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(2) Korean Supreme Court (대법원) Supreme Court of Korea, Judgement, 90DaKa8845 (Oct. 23, 1990).

(3) Appeals Courts (고등법원) Seoul High Court, 2003Na80798 (Jan. 25, 2005).

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Hyungbae Kim, Kyuwan Kim & Myungsook Kim, Lecture on Civil Law Theory, at 50-51 (8th ed. 2009)

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Jeongho, Kim, *A Study on the Path to Introduce the Multiple Derivative Suit in Korea*, Journal of Business Administration & Law Vol. 23, No.4, 2013. at 209-254.

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Samsung v. Elliott*

- Primarily Presenting Domestic Legal Issues in Korea Surrounding the Merger between Samsung C&T and Cheil Industries -

*Prof. Dr. Jeong Ho Kim***

ABSTRACT

This paper explores the corporate governance and corporate finance problems surrounding the famous merger between Samsung C&T and Cheil Industries, Co. Ltd. in the year of 2015. The author tries at first a general scanning on the problem of global convergence in corporate governance and its limits. He goes thereafter onto the main problems of this article, namely the motives and backgrounds of this Merger. In furtherance he explores thereafter the relating issues surrounding the merger. Among others he wrote on the relationship between the appraisal right and synergy generated by the reorganisation. In conclusion he describes the confrontation between Samsung and Elliott as a conflict of corporate culture.

KEYWORDS: International Convergence in Corporate Governance and Its Limits ; Fairness of the Merger Ratio ; Geo-Political Elements in Corporate Governance ; Socio-Cultural Element in Corporate Governance ; Stewardship Code ; Appraisal Right & Synergy ; ISDS Issue ; Stock Acquisition Right in Japanese Company Act 2006 ; Shareholder Activism ; Nakariseba Price ; Synergy Distribution Price.

* This article was made on the basis of my presentation, which took place on November 19, 2018 in UC Irvine as UCI Law & Korea University Law School Joint Symposium 2018.
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I. Prelude

The summer 2015 was hot in Korea because of the world famous merger between Samsung C&T (in following as 'S' abbreviated) and Cheil Industries, Co. Ltd.(in following as 'C' abbreviated). This merger was treated practically as an international issue, although the restructuring took place between korean-domestic and inner-Samsung affiliates. Due to the shareholder activism by Elliott Associates L.P. (following in this article abbreviated as ‘Elliott’ or simply as ‘E’) and due to the 4.1% shareholding of S in Samsung Electronics Co., this merger became world famous and practically handled as CEO-succesion project in Samsung Empire, after the Samsung Group’s CEO & Chairman Mr. Kunhee Lee had been hospitalized incapacitated in Samsung Medical Centre in Seoul more than a year after suffering a massive heart attack. Furthermore this merger inspired warm sympathy and patriotism by Korean people, because of the Samsung’s outstanding position in Korean economic circle. It has been a long and winding road from the ‘Everland Convertible Bond’ to this merger for Samsung as the biggest company group in Korea to complete the CEO-succession.

In the midst of the merger, there came suddenly the U.S. hedge fund Elliott Management to object the restructuring. After the appearance of its shareholder activism, the merger developped itself suddenly to a global issue. Elliot maintained, that this merger is unfair to the minority shareholders of Samsung C&T and so it has to apply for a provisional injunction, to prohibit any resolution of shareholder meeting to approve the merger. It applied also for a provisional injunction, not to permit any selling off the treasury stocks to KCC and not to allow any voting right thereof. The District Court of Seoul rejected meanwhile all the requests of Elliott in July 2015, and the merger was approved by both of the participating company's shareholder meeting.

Elliott exercised the appraisal right August 2015 and the merger was registered September 2015, and it seems that the procedure is completed peacefully. But the merger has left lots of legal questions on corporate governance in Korea unanswered, and raised fundamental questions thereon. In this article the author looked back this takeover deal, put hot questions together and tried some of them analyzed.

II. Litigations and Proceedings

A. Injunctions against the Merger

The boards of Samsung C&T Co. Ltd (following as 'S' abbreviated) and Cheil Industries, Co. Ltd. (following as 'C' abbreviated), which were at that time simultaneously the affiliates of Samsung Group, announced May 26th 2015 'the Merger', by which C becomes the acquiror and S the target. June 3rd 2015 Elliot Management LLP (in the following as 'E' abbreviated) announced to reject the merger because of the unfair merger ratio, by which the shareholders of S get only 0.35 share of C in exchange of 1 S share. June 4th 2015 E turned itself as shareholder activist, proclaiming simultaneously various shareholder proposals. S requested KCC the role of white knight. KCC accepted it and bought 8,990,000 treasury stocks of S. In the end E filed June 25th 2015 injunction against the merger, but the court ruled July 2015 in favor of Samsung, proclaiming that the merger didn't have any legal defect from the viewpoint of domestic legal situation in Korea.[1]

[1] Seoul Central District Court (50th Civil Division), decided in July 1, 2015, Docket Nr. 2015 Ka Hap 80852; Seoul Hight Court, decided in July 16, 2015, Docket Nr. 2015 Ra 20485 [Injunction against the convocation and resolution of the shareholder meeting] ; Seoul Central District Court, decided in July 7, 2015, Docket Nr. 2015 Ka Hap 80597; Seoul Hight Court, decided in July 16, 2015, Docket Nr. 2015 Ra 20503 [Injunction against the selling off of the treasury stocks to KCC].

B. Litigation against the Merger

National Pension Fund of Korea decided internally to vote for the Merger. It has had 11% of S stocks. In contrast ISS and Il-Sung Pharmaceutical Co. decided to vote against the Merger. July 17 2015 the shareholder meeting of both corporations took place at the same day, approving the reorganisation plan mainly for the CEO succession in the Samsung Empire. September 1st 2015 came the merger in effect and the commercial name of C became Samsung C&T (New). Il-Sung Pharmaceutical Co. Ltd., one of minority shareholders of the old S filed suit against the effectiveness of the merger, but the Seoul Central District Court ruled in favor of Samsung.[2]

C. Appraisal Proceedings

August 6th 2015 the dissenting shareholders of S exercised the appraisal right. The above-mentioned Il-Sung Pharmaceutical Co. and the american hedge fund Elliot jointly filed an appraisal proceeding to fix the fair value of the old S stock[3]. The Court decided that the fair value of S is 57,324 Korean Won(₩) after applying the domestic rules in Korean Capital Market Act(in following as 'KCMA' abbreviated) and its Enforcement Ordinance(in following as 'KCMAEO' abbreviated).[4] Plaintiffs appealed against the decision and the appeal Court, Seoul High Court made a renewed ruling for fair price at 66,602 Won, 9,368 Won more than by the District Court.[5] The post-merger company appealed again against this decision, and now the case stays at Korean Supreme Court.[6]

III. Domestic Legal Issues Surrounding the Merger

A. International Convergence in Corporate Governance and its Limits

The corporations in Korea, like any other ones in the world, are taking a pivotal role in terms of leading the nation’s economy. Facing the financial crisis

2 Seoul Central District Court (16th Civil Division), sentenced October 19, 2017, Docket Nr. 2016 Ka Hap 510827.

3 In this article, 'the old S' means Samsung C&T before the merger and the new one means after the merger.

4 Seoul Central District Court, decided in January 27, 2016, Docket Nr. 2015 Bi Hap 91, 92(consolidated), 30037(consolidated).

5 Seoul High Court, decided in May 30, 2016, Docket Nr. 2016 Ra 20189, 20190(consolidated), 20192(consolidated).

6 Under Docket Nr. 2016 Ma 5394, 5395, 5396 (consolidated).

in 1997(IMF crisis), the companies had no choice but to change the corporate governance system under the irresistible current of global financial market. The phenomenon of so-called 'global convergence in corporate governance' is mainly represented as a profit centered model for the shareholders' in its governance structure of both ownership and the management ; which, as a result, accelerated the pro-american way of operating our own corporate law system. Under the circumstances, the 'outside directorship' and the former based 'audit committee system' have been adopted to Korean Commercial Code in late 1990s as well as remain there chances for adopting the institutions such as ; american officer system, 'double derivative suit' and 'problem of abusing corporate opportunity'. Though the 17th National Assembly(2004~2008) could not accomplish enacting the "new company law", those issues were still on the table for the 18th National Assembly(2008~2012). In the end the revised 'new company law' was born in the year of 2011 adopting some of them.

The issue of 'international convergence in corporate governance' is no exception in Japan and Germany. Japan, for instance, enacted the 'New Company Law' in 2006 and this allowed 20 choices for the composition of management in a variety of sizes demonstrating Japanese style of deregulation. For the companies with 3 board committees (audit, compensation and nomination committee), however, they are under the control of senior officer system.[7] In case of Germany, known for the representative state of continental-european civil law, it has codified the 'derivative suit'[8] and the 'business judgement rule'[9] from America in its 'Aktiengesetz'(The Law of Public Corporation). It is probable to predict the drastic transformation of a conventional two-tier governance model (supervisory and management board) into an american one-tier board system, provided that the bank's ownership diminishes. It seems we can not deny the fact that companies have jumped into the boat of 'global convergence in corporate governance' powered by highly developed information technology and the globalization of financial market.

Given the consideration of socio-cultural factor as well as finance market or the legal regulation to determine the governance model, the question raises : does this boat constantly head for the America? Would there be any obstacles or limitations? Today, transparency is not the only criteria when selecting a perfect model. The modern theories related to corporate governance do emphasize the correlation between corporate governance and firm performance.[10] In other words, the improvement of corporate governance can

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[7] ss. 2 (12), 327, 402 Japanese Company Act 2006.

[8] ss. 148, 149 German Stock Corporation Law.

[9] s. 93 (1) German Stock Corporation Law.

[10] Agrawal/Knoeber, Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders, 31 J. Fin. & Quant. Analysis, 377 (1996) ; Bhagat/Black, The Non-Correlation between Board Independence and Long-Term Firm Performance, 27 J. Corp.

not be an ultimate goal itself ; rather it is an important means to reach the efficiency of management. Scholars in business administrations have already released quite a number of empirical articles about it.[11] This study was brought up possible not until late 1990s, times of which eager for enacting the 'best practice for corporate governance' were spread all over the world when taking no attention to the firm performance at all. Soon after the correlation between corporate governance and firm performance has been researched, conceptions and the trend for the international convergence in corporate governance began to change. In addition, each nation has different structure of corporate governance ; U.S. has widely-spread structure while nations in Asia and Europe have another type. It seems uneasy to get over this difference before long. Also under the unique "Chaebul-Structure", it is unlikely for outside directorship to root in Korea shortly.

Even in the English-speaking world, governance structure of management does not take the same form but is different from the nations. In U.S., for example, though executive officer system is put in statutory form, most of the CEOs in large corporations commonly have the position of chairman – in short 'CEO duality'. That is to say, division of execution and audit is in fact rarely found in a real business field. In this perspective, the article 393 in Korean Commercial Code should not be treated as an old-fashioned one but should be newly recognized as a right one. Where such system operates, CEO has exclusive right to access management information through the process of convocation, operation and the selection of agenda in the board of directors. What is more, CEO is empowered to assign the successor and the board in all respects and grants the decision made. It might be considered as a dangerous system from the 'good governance' view. CEO duality, however, works better despite the strong argue from the 'Agency Theory'[12] ; separation of management and the board. In accordance with the custom in America, newly

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L. [Journal of Corporation Law], 231 (2002).

11 Agrawal/Knoeber, "Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders", 31 J. Fin. & Quant. Analysis 377(1996) ; Bhagat/Black, "The Non-Correlation Between Board Independence and Long-Term Firm Performance", 27 J. Corp. L. 231 (2002) ; Donaldson/Davis, "Stewardship Theory or Agency Theory ; CEO Governance and Shareholder Returns", Australian Journal of Management, Vol. 16, Nr. 1 (1991), pp. 49 ff. ; Hurther, "An Empirical Test of the Effect of Board Size on Firm Efficiency", (1996) Economic Letters, 54, No. 3, pp. 259~264 ; Klein, "Firm Performance and Board Committee Structure", Journal of Law and Economics 41 (April 1998), pp. 275~303 ; Maretno A. Harjoto/Hoje Jo, The Power of CEO and Firm Performance, 2008 ; Rechner/Dalton, "CEO Duality and Organizational Performance ; A Longitudinal Analysis", Strategic Management Journal, Vol. 12, Nr. 2, pp. 155~160 ; Yermack, David, "Higher Market Valuation of Companies with a small Board of Directors", [1996] Journal of Financial Economics, Vol. Nr. 2, pp. 185~211 etc.

12 Donaldson/Davis, "Stewardship Theory or Agency Theory ; CEO Governance and Shareholder Returns", Australian Journal of Management, Vol. 16, Nr. 1 (1991), pp. 49 ff.

selected CEO can refuse the position if not coincidently offered as the board chairman. As opposed to this, nations like Canada, U.K. and Australia take a system that both positions are separated apart. The thing is no certain reason can be found to explain what determines these differences.

B. Motives and Backgrounds of the Merger

S and C jointly announced before the Merger that it enables synergy effect for both companies, resulting in cost reduction and development of bio-industries for the post-merger company. The dissenting shareholders opposed, saying following : "The synergy effect is not so trustworthy and the true purpose of the merger focuses only on the CEO-succession in Samsung Empire. So the purpose of the merger was totally illegitimate and it can lead to nullity of the merger."

1. Characteristics of Shareownership in Korean Corporate Groups

There are worldwide especially three types of shareownership. The first one is anglo-american 'widely-held'. The second one is 'bank-owned', that can be seen especially in Japan and in Germany. The third one is 'family-owned', that finds itself primarily in Sweden and in Korea. In Sweden there is a famous family naming Wallenberg, which predominantly reigns the swedish economy. In Korea it is prevalent, that the main economic activity is performed by company groups ('Chaebul'), characterized as *family-owned*. For example family "Lee" dominates Samsung, family "Chung" Hyundai, family Ku "LG", family Shin "Lotte" and family "Choi" SK etc.

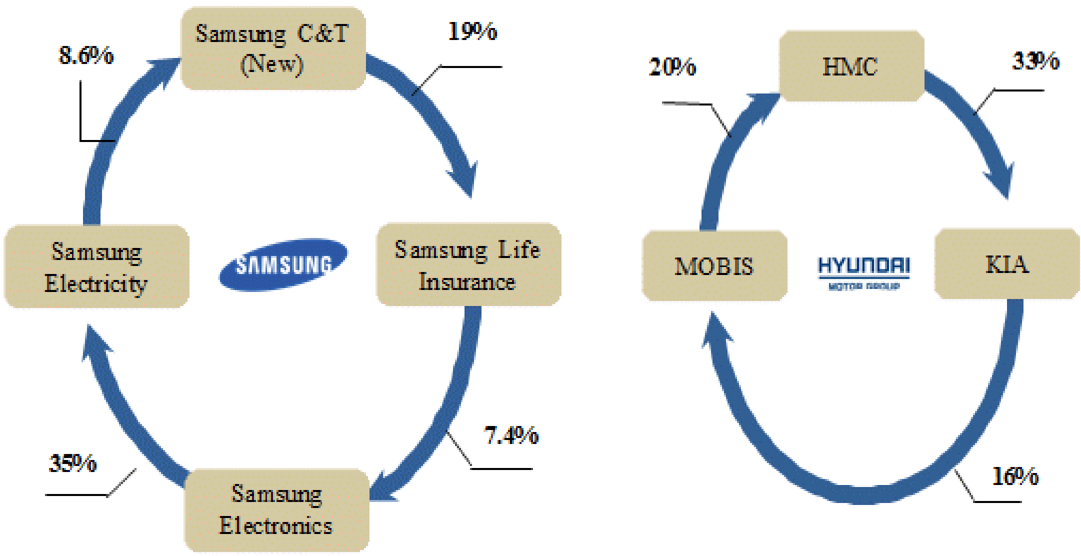
The shareownership in Korean conglomerate characterises itself as circular style. We can find many rings in a company group in Korea, e.g., the ring Samsung C&T(new) → Samsung Life Insurance → Samsung Electronics → Samsung Electricity → Samsung C&T (new)[13] and the ring Hyundai Mobis → Hyundai Motor → KIA → Hyundai Mobis etc. There are also many metrics-type capital participations in Lotte Group.

The Fair Trade Commission of Korea has ordered and recommended since long in the wake of economic democratization to demolish the rings and to establish a holding structure in every industrial sector. Not a few corporate groups in Korea including LG and SK have meanwhile complied with the government-driven stream and broken the rings and established holding

[13] This is the most famous circular ring in Korea. We can describe it as "One Ring" from "the Lord of the Ring".

companies to erase the earmark, tainted as a negative symbol permitting the founding family to use fictitious voting right.

<Circular Ownership of Korean Conglomerates>



2. Characteristics of Management Structure of Korean Corporate Group

Let's get started with comparing the management structures of world prominent corporations. It is prevalent for a widely-held corporation to experience a 'Berle-Means-style' separation of management and ownership. The director primacy is also prevalent especially in a public corporation like General Electric or General Motors. The board is composed normally with an overwhelming portion of outside directors.

SONY has introduced the american officer system to enhance the independency of the board with outside directorship.[14] In contrast Toyota didn't know the outside directorship until 2013. Regarding firm performance the both stood in extreme ends of one bar. Sony lost her prosperity as Samsung dominated the digitalized mobile market since 2005. In contrast Toyota won the prosperity as number one car-maker worldwide. It has also won the first rank in Tokyo Stock Exchange for an aggregate stock price. The number of outside directors in a board is not so crucial for firm performance. There is no

14 Chang, Sea-jin, *Sony vs. Samsung* - The Inside Story of the Electronics' Giants Battle for Global Supremacy -, John Wiley & Sons, 2008 ; (Korean translation) Sallim Publishing, 2008, pp. 233.

'one-size-fits-all' approach for management structure. No single structure works for every corporation.[15]

The public corporations like Samsung Electronics or Hyundai Motors Company have never introduced yet the american officer system - so to speak dual structure of director-officer system - though the Korean Commercial Code has permitted it since 2011 in sections 408-2 ff. They have only one board to perform the function of management and monitoring simultaneously in one tier. The Board consists frequently of 5 outside directors and 4 inside directors in manufacturing and services sectors, like Hyundai Motors Company. In finance sector there were normally more directors chosen than in manufacturing sector, for example the KB Financial Holdings had 13, Shinhan Financial Holdings 12, though the former has now only 8. Recently BoD of Samsung Electronics has increased number of directors to 11 from 9 and proclaimed "management with board primacy", but it's not yet firmly confirmed, for Samsung to clearly abandon the traditional "top-down"(owner→future strategy dept.→officers of affiliates) system.

3. Geo-political and Socio-Cultural Elements in Corporate Governance

Let's get started with comparing the governance structures of corporations in U.S., in Japan and in Korea.

U.S. has vast geo-space from Atlantic to Pacific and it leads to the phenominon 'shareholder passivity'. The shareholders in U.S. public corporations seldom attend the annual meeting, though they are eager to be there. All they can do is to send their proxy statements per mail. The outside directors should be active on behalf of their shareholders.

Japan could not escape itself from the traditional and consistant natural disasters, e.g. earthquake, tsunami etc. Thanks to the disaster drill already done from the ages of Kindergarten the Japanese people enjoys to be acclimated to act as a group. The spirit of 'Kaizen', that the Toyota employees proudly showed worldwide, was in fact the product of the severe natural disaster. Until 2013 the boards of Toyota and Canon have never known the american style outside directorship.[16]

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15 Charles Tribbett, Splitting the CEO & Chairman Roles – Yes or No? Let company needs rather activist pressures guide your decision, The Corporate Board, November/December 2012, pp. 3-7, at p. 4.

16 "Toyota appoints first-ever outside directors" [Published: Mar 6, 2013 7:29 a.m. ET] TOKYO-- "Toyota Motor Corp. (7203.TO) on Wednesday announced its biggest management overhaul since founding family scion Akio Toyoda took over as president four years ago. The moves will open up the world's No. 1 auto maker to its first outside directors in its 76-year history, while accelerating a generational change in the executive ranks and streamlining the organization's decision-making." <https://www.marketwatch.com/Industries /Automobiles>

Korea has experienced frequently foreign attacks. Korean peninsula lies between Chinese Continent and Japanese Islands. When China became strong, e. g. in Won Dynasty with Genghis Khan, the political power penetrated through korean peninsula to Japanese Islands. In contrast, when Japan became strong, e.g. in 20th century imperialism, the power penetrated through Peninsula to Continent. Korea was seldom been in calmness, although it has the name “The Land of Morning Calm”. The family-oriented corporate atmosphere is the historical product of geo-political situation. Korean people was closer to his relatives than to the outside world. The founder of Koryo dynasty, the King Wang Gun married 29 wives to strengthen his control over all the provinces in the peninsula.

Nobody denies nowadays in Korea, that the Delaware Corporate Law has been firmly rooted in this region. Due to the long lasting political and economic ties between the two nations, the convergence in corporate governance is to be easily ongoing. Especially in the field of fiduciary duty of directors and officers, normally at the publicly held corporations in Korea, this trend seems to be at the highest level. The business judgement standard[17], Caremark standard[18] and the so called 'Red-flag' test[19] have been firmly rooted in various judicial reviews in Korea.[20] Furthermore in takeover-law for example, we can find the same trend in the famous court case of "Hyundai Elevator" from the Korean District Court of Suwon (Yeo-ju Sub-District), where the judge used the ‘Unocal’ standard[21] for his reasoning.[22] The ‘valid business purpose’ test out of Singer v. Magnavox[23] for freeze-out situations was also codified in the revised (in the year of 2011) Korean Commercial Code(s. 360-24).

As a limiting factor to the phenomenon "convergence in corporate governance" in the region, we can, first of all, point out the *geographical difference*, which is released from the two nations. In U.S., the reasonable-thinking shareholders of publicly held corporations never attend the shareholders' meeting due to the 'cost and time' problem. But in Korea, a shareholder can visit his or her shareholders' meeting with ease. So the litigation over the procedural defectness from the resolutions of shareholder meeting is so popular in the region as a derivative suit in U. S.

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17 E. g. Smith v. Van Gorkom, 488 A. 2d 858 (Del. 1985).

18 In re Caremark International Inc. Derivative Litigation, 698 A. 2d 959 (Del. Ch. 1996).

19 Graham v. Allis-Chalmers Manufacturing Co., 188 A. 2d 125 (Del. 1963).

20 [*Business Judgment Rule*] Supreme Court of Korea, Sentenced October 28, 2005, Docket Nr. 2003 Da 69638 [Samsung Electronics Shareholder Derivative Litigation] etc. ; [*Caremark Duty*] Supreme Court of Korea, Sentenced September 11, 2008, Docket Nr. 2006 Da 68636 [Re Daewoo Fraudulent Accounting]; [*Red-Flag-Test*] Supreme Court of Korea, Sentenced, Dec. 13, 2007, Docket Nr. 2007 Da 60080 [Re Dong-A Construction Co.]

21 Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946 (Del. 1985).

22 Suwon District Court Yeo-Ju Sub-Division, Sentenced Dec. 12, 2003, Docket Nr. 2003 Ka Hap 369.

23 380 A. 2d 969 (Del. 1977).

Until now the convergence has been always in one-way path ; namely from U.S. to Korea. But it could probably be also possible in the future, that a convergence in corporate governance takes place among the nations interactively. Korea had been always importing american culture ; blue jeans, Starbucks, Coke, McDonalds' and Hollywood movies, etc. But recently the nation proudly exports besides its products with highest quality also the K-Pop music with Korean lylics. Countless parody videos have been produced as if to complete with each other in the U.S., even though many Americans still find its Korean lyrics hard to understand. It became so familiar also outside U.S. to see the massive group dancers shouting “Gangnam Style !”.

In Korea there prevails traditionally the Confucianism countrywide, which had been the nation's philosophy during the last dynasty ‘Chosun’ in that peninsula.[24] Korea is also a racially homogeneous country. The Confucian heritige and the racial homogeneity enable the path to a hierarchical structure of corporate governance, in especially, in the management system in Korean conglomerates. The above-mentioned ‘top-down’ phenominon in Samsung Group could be counted as an appropriate example.

4. Legitimacy of the Merger

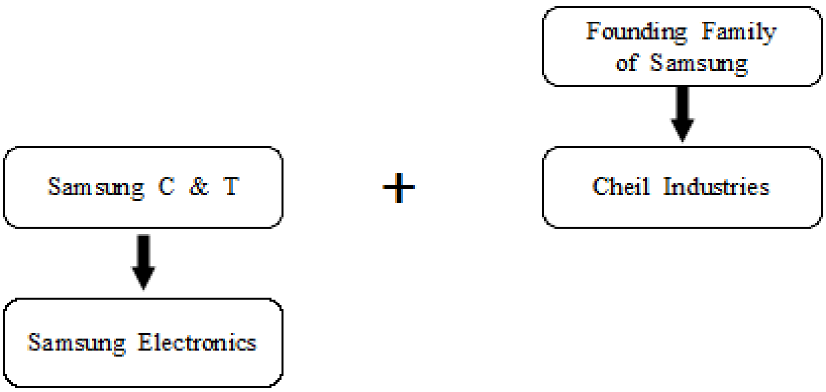
Regarding the purpose of the merger this restructuring could be evaluated as illegitimate from the viewpoints of the investors of participating companies. But if we see the fleet from the bird eye view, we can find a totally different landscape. The Samsung Empire consists of appoximately 70 affiliates. The above-mentioned S and C are only the two of them. As one member of this fleet, S could not survive without its help or support. Nobody denies that the investors of S have also enjoyed the benefit generated by the fleet until now. S existed for the entire group, and the group existed for the individual S. They have tried until now peacefully common benefit. There came suddenly a considerable change of situation in the CEO-succession, when Mr. Kunhee Lee was hospitalized.

To solve the problem of legitimacy of the merger, we can go to the principles of proportionality, which has been developed originally in the field of public law and has made there three traditional requirements, ① the legitimacy of the ends, ② the suitability of the means and ③ the principle of less restrictive alternative. This doctrine can be analogized also in the field of private law for comparable situations, e.g., for the legitimacy of issuing convertible bonds to the non-shareholder third party or for the legitimacy of the

[24] Licht, “Legal Plug-Ins : Cultural Distance, Cross-Listing, and Corporate Governance Reform”, 22 Berkely J. Int'l L. 195 [2004], at p. 215(It was also well described there about the “Five Relationships” formulated by classical Chinese philosophers).

defense tactic chosen by the target's boardroom by the hostile takeover bids[25], etc.

There came suddenly an irresistible needs for Samsung to conserve the management right and group interest by solidifying the founding family's grip over the group. The merger solidifies the grip over the Samsung Electronics, a main company in Samsung Empire with about 70% of entire sales volume. Due to the 4.1% shareholding of S in Samsung Electronics, there were no other means available to enable the ends.



We could expect one more possibility to approach the same goal, analogizing the principles of "Rozenblum", that the French Supreme Court rendered in the year of 1985.[26] The case released three requirements ; ① stable structure of the group, ② implementing a coherent group policy, ③ equitable intra-group distribution of cost and revenues.[27] The principle of this litigation could be analogized for finding the legitimacy of the Merger, though the case was a criminal one.

C. Miscellaneous Domestic Problems

1. Transfer of the Treasury Stocks to KCC

It was also discussed, whether the transfer of treasury stocks by Samsung C&T direct before the shareholder meeting to KCC, Corp. was legally effective. According to the Korean Commercial Code the board can sell off the treasury

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[25] The Unocal Case rules, of course, this situation.
[26] Cass. Crim. 4. fevr., 1985, Rev. soc. 1985 = Cour de cassation (1985) Revue de Societes 648.
[27] 1985 Revue des Societes 648 ; Kraakman et. al., The Anatomy of Corporate Law, 2nd ed., Oxford University Press, p. 141.

shares without any shareholder approval to a third party, only if the board approves(s. 342 KCC). S sold 8% of its shares to KCC, Corp. It was so called the 'white knight' for S.

The background of section 342 KCC originates from the following situation. Korean Commercial Code doesn't have any comparable sort of defense tools like 'poison pill' or 'dual class stock' that can be found in various civilized countries. Japanese Company Act 2006 has introduced the legal institute of stock acquisition right, so called "the japanese poison pill". In Bulldog-Sauce case the Supreme Court of Japan justified 2007 the use of poison pill as legitimate, if the Unocal tests are simultaneously met.[28]

It's not difficult nowadays in Japan to find any practical examples applying the 'stock acquisition right', codified in §§ 236-294 Japanese Company Act(2006). First of all the 'stock acquisition right' plays an important role as *investment sweetner* in corporate finance sector. Especially, the words 'equity commitment line', 'moving strike price warrant', 'rights offering' or 'private investment in public equities(PIPEs)' could be easily enumerated nowadays in japanese corporate finance. Secondly the japanese stock acquisition right has been frequently used as a *defense tool*, easily called as 'japanese poison pill', at the hostile M&A situation. The most famous judicial case could be probably the "Bull-dog Sauce" in the year of 2007, when the Supreme Court of Japan confirmed the legitimacy of japanese poison pill. At last the stock acquisition right assumes some variant roles in the japanese business circle such as an *incentive tool* for the executive compensation or as reward to the shareholder etc.

Korean Commercial Code has already codified some examples of stock acquisition right ; they are the sections on the convertible bond (ss. 513-516 KCC), bond with warrant (ss. 516-2 ~ 516-11) and stock option for employee or executive compensation (ss. 340-2 ~ 340-4). But until now it cannot be seen there any regulations on the 'poinson pill' or on the 'dual class stock', like in many other civilised countries. In the mean time, especially in the aftermath of the famous merger between Samsung C&T and Cheil Industry and in the wake of the shareholder activism from the hedge fund Elliot Management, it is nowadays in Korean business circle urgently needed to codify any sort of 'poison pill' in its Commercial Code.

Korean Commercial Code doesn't have any similar sort of dual class stock either.[29] There is practically only one way left to defend the management right ;

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[28] Supreme Court of Japan, decided Aug. 7, 2007, Hanrei Times Vol. 1252, pp. 152 ff.

[29] Japan has now an example of company with dual class stock. The name of it is "Cyberdyne Inc.", which produces the exo-skeleton suits. There are two classes of shares in this company ; class A and class B. Shareholders with class B can have 10 votes per share, although shareholders with class A have only one vote per share.

to transfer the treasury stocks or to issue new stocks (CB, BW can be added) to a possible white knight.

2. Fairness of Merger Ratio

According to the statutory ruling in Korea the ratio 1 : 0.35 was legitimate. The Korean Capital Market Act (in following as 'KCMA' abbreviated) and its Enforcement Ordinance (in following as 'KCMAEO' abbreviated) jointly rule the method for merger ratio between the listed companies [s. 165-4 (1) KCMA ; s. 176-5 (1) KCMAEO]. It shows in concreto as follows. At first the following three results should be fixed. First one is the one month average closing price in stock market with respect to the daily trading volume beginning from the day before the board resolution approving the merger. Second one is the one week average closing price calculated by the above-mentioned way. And the third one is the closing price of the day before the board approval. The average price of these three results represents the share price for calculating the merger ratio. The both companies calculated the prices for merger ratio following the above-mentioned. The price of S stock was 57,234 Korean Won, and the price of C stock was 156,493 Korean Won. The outcome was in consequence 1 : 0.35. The shareholders of S get 0.35 share of C in exchange of 1 S share. S and C have consequently never violated the statutory ruling regarding the merger ratio.[30]

Nevertheless there came again and again disputes surrounding the *timing of the merger*. Samsung said that the day of the board approval was legitimately fixed. The minority shareholders of S say in contrast that the stock price of S was at the lowest level at that day, in contrast, the price of C at the highest.

IV. Relating Issues to the Merger

A. Appraisal Right & Synergy

This Merger gave corporate lawyers in Korea opportunity to deepen their experience on the legal institute of dissenter's appraisal right. It became nowadays easy for everyone in Korea to find a reportage on the dissenting shareholders' appraisal right released by various media. Almost all nations over the world acknowledge this institute to provide an effective tool for the minority protection. This merger gave in especially corporate lawyers in Korea to analyze the relationship between the appraisal right and synergy value.

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[30] According to the provisions of KCMAEO, the directors of S, had, of course, the discretionary power to adjust the ratio up to 10% of stock price. But it seems difficult to blame them due to the shareholder approval and due to the existence of group watch tower.

1. Legal Frame Surrounding the Distribution of Synergy

It's normal for a post-merger company to enjoy the synergistic value. Has the merger normally planned and performed, there comes the synergy value. This extra value from the reorganisation should be distributed fairly to the shareholders of each parties. But that's not always the case, especially in the event of merger as related-party-transaction (in following as 'RPT' abbreviated).

In the event of merger as arm's length transaction(in following as 'ALT' abbreviated) there dominates the principles of private autonomy, that is to say, that the courts need not to intervene to find any fair value of the shares by appraisal proceedings. The agreed price by the parties in an M&A deal prevails as fair price anyway.[31]

Also in the event of merger as RPT, there comes though certain possibility for private autonomy, if procedural fairness surrounding the restructuring has been completely guaranteed. The agreed merger price is deemed to be fair in an appraisal proceeding in this case.[32]

When the merger is RPT and the procedural fairness is not guaranteed, the minority shareholders of merged company should be in general protected by the court. Delaware Supreme Court says, " ... It is significant that section 262[33] now mandates the determination of fair value based upon 'all relevant factors'. Only the speculative elements of value that may arise from the 'accomplishment or expectation' of the merger are excluded. We take this to be a very narrow exception...."[34]

2. Change in Corporate Value and Synergy Distribution

According to the japanese law, there are three types of synergy distribution as follows.[35]: In the first one, the entire corporate value stays before and after the reorganisation unchanged. In this case the fair value is 'pro rata going concern value', which becomes practically similar to a 'but-for' price, in japanese, "Nakariseba-Price".[36]

In the second one, the corporate value is after restructuring diminished. In this case the fair value is once more the above-mentioned 'but-for' price.[37] In

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[31] M.P.M. Enterprises, Inc. v. Gilbert, 731 A. 2d 790 (Del. 1990).
[32] Golden Telecom, Inc. v. Global GT LP, 11 A. 3d 214 (Del. 2010).
[33] s. 262 Delaware General Corporation Act.
[34] Weinberger v. UOP, 457 A. 2d 701, 713.
[35] Alan K. Koh, "Appraising Japan's Appraisal Remedy", 62 A. J. Comp. L. [2014] 417, 440.
[36] Rakuten v. TBS, Japan Supreme Court, Sentenced in April 21, 2011, 65-3 Minshŭ 1311.
[37] Re Intelligence, Japan Supreme Court, Sentenced in April 26, 2011, Hanrei Times, No 1352 (Oct. 2011), p. 135.

the third and last one, the merger generates plus synergy. In this case the fair value consists of the 'but-for' price plus fairly distributed synergy value.[38]

<Japanese Case Law regarding the relationship between the appraisal right & synergy>

The key question in appraisal is how the shares are appraised.[39] Japanese Supreme Court released recently three important cases in relation to the synergy problem by stock valuation. They are the Rakuten vs. TBS, Re Intelligence and the Tecmo.

(i) Rakuten vs. TBS[40] : It is the common law rule of Japanese Supreme Court, where the entire corporate value stays before and after the reorganisation unchanged. Here prevails the principle of 'pro-rata going concern value', which is practically as same as 'but for' (nakariseba) price.

(ii) Re Intelligence[41] : It is the common law rule of Japanese Supreme Court, where the entire corporate value is diminished following the restructuring. Here prevails the principle of 'but for' price, which is justified by the viewpoint, that the aim of appraisal right is to compensate the minority shareholders.

(iii) Re Tecmo[42] : It is the common law rule of Japanese Supreme Court, where the entire corporate value is increased following the restructuring. It is the case, where the reorganisation generates positive synergy. Here prevails the principle of synergy considering price, which is justified from the viewpoint, that the aim of appraisal is to distribute the positive synergy to the minority shareholders. In this case, 'fair value' is 'fair synergy distribution value', that is practically as same as 'but for' price plus fairly distributed synergy value.

3. Distribution of Synergy in this Merger

This merger could be described as "horizontal" related-party-transaction. Due to the capital participation, RPT is normally described as "hierarchical" one frequently in a parent-subsidiary-relation. In contrast by "horizontal" RPT there is no parent-subsidiary-relation, which is replaced in “horizontal” RPT by the power of the group watch-tower. It seems to be undoubtedly that the Future Strategy Department of the Samsung has made intervention consistently.

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[38] Re Tecmo, Japan Supreme Court, Sentenced in February 29, 2012, 66-3 Minshŭ 1784 ; SANYO v. Panasonic, Osaka District Court, Sentenced in April 27, 2012, 1396 Kin'yŭ Shoji Hanrei 43.

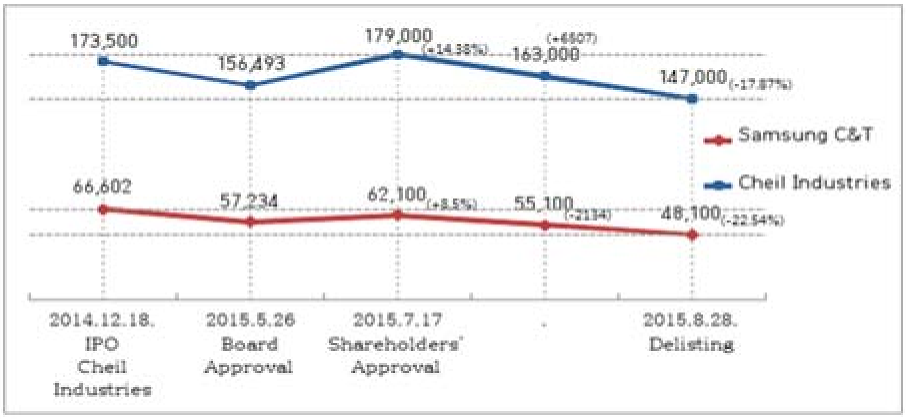
[39] Alan K. Koh, "Appraising Japan's Appraisal Remedy", 62 Am. J. Comp. L. 417, at 431.

[40] Rakuten v. TBS, Japan Supreme Court, Sentenced in April 21, 2011, 65-3 Minshŭ 1311.

[41] Re Intelligence, Japan Supreme Court, Sentenced in April 26, 2011,

[42] Re Tecmo, Japan Supreme Court, Sentenced in February 29, 2012, 66-3 Minshŭ 1784.

The market price of S and C stock was ascending without pause to the maximum in July 17th 2015, when the shareholder meeting took place to approve the merger. But the both stock prices entered without any interruption into the descending phase in the aftermath of shareholder approval at that day. In consequence it became difficult to confirm any positive synergy effect of this merger. In the event of non-existence of plus synergy there came the rule of 'but-for' price, in Japanese the rule of 'nakariseba'-price.



B. Stewardship Code Problem

Stewardship Code is "a set of good practice principles to enhance the quality of engagement between asset managers and companies, to help improve long-term value creation for shareholders. The Code encourages inverstors to be active and responsible stewards of companies in which they invest. Effective stewardship benefits companies, investors and economy as a whole."[43]

It is introduced in Korea on the basis of self-regulating. There is no legal obligation of each company to introduce it. There are only a few cases until now reported, that the code was introduced. The Nationl Pension Fund introduced the Code end of July 2018. It's very hot now in Korea how to evaluate the Code in relation to the internal governance of the public corporation.

The Pros say that the improper business decision like this Merger can be avoided in advance due to the enhanced scrutiny of monitoring function. Public Pension Fund can vote freely against the decision of the board, thinking the

[43] AVIVA, "U.K. Stewardship Code".

board decision as improper.[44] The Contras say that the "pension socialism" is possible, provided that the Code will be implemented

C. ISD (Investor-State Dispute) Issue

Bloomberg reported last May that "Elliott Management Corp. is seeking compensation from South Korea over how its former administration intervened in the merger of Samsung C&T Corp. and Cheil Industries Inc. in 2015, a deal that led to a massive corruption scandal in the country.... Singer sent a notice of intent on April 13 to South Korea's Justice Ministry to ask for resolution over its objections regarding the merger, a government official said. If the two sides fail to resolve the issue within three months of a notice, a U.S. investor can initiate an investor-state dispute against South Korea under Korea-U.S. free trade agreement, the official said."[45]

D. Hyundai vs. Elliot

In the year of 2018 there came a second wave of shareholder activism from Elliott Management targeting once more a korean conglomerate.[46] It targeted this time the Hyundai Motor Company Group, demanding various points through shareholder proposal. The entire legal situation is almost similar as in the inner-Samsung merger of 2015.

But this time the Hyundai Motor Group suddenly revoked the reorganization plan. The heir of Hyundai Empire, Mr. Eui-Sun Chung, temporarily gave up his plan to solidify the grip over the auto giant, leaving various legal problems unanswered and leaving another round of shareholder activism to another korean conglomerates unexcluded.

V. Epilogue

It had been a hot topic until financial crisis with sub-prime mortgage in early 21st century, whether the international convergence in corporate governance can be justified in the wake of globalization with neo-liberalism

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44 Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered", 93 Colum. L. Rev. 795 (1993) ; John C. Coffee Jr., "Liquidity versus Control ; The Institutional Investors as Corporate Monitor", 91 Colum. L. Rev. 1277, 1321 (1991).

45 By Scott Deveau, Bloomberg, May 2, 2018.

46 Business News, April 23, 2018 / 7:15 PM, "Activist fund Elliott ramps up pressure on South Korean auto giant Hyundai" / Reporting by Ju-min Park, Hyunjoo Jin : "SEOUL (Reuters) - U.S. activist hedge fund Elliott Management dismissed Hyundai Motor Group's restructuring plan as insufficient on Monday and called on the South Korean conglomerate to adopt a holding company strategy and appoint more independent board members."

and whether the ultimate destination should be that of U.S. public corporations armed with outside directorship and board primacy. Not a few scholars were for the question and showed theories like path dependency[47], formal, contractual or functional convergence[48] etc. Nowadays we cannot find any following scenes theoreof.

The confrontation between Samsung and Elliott can be described as "*conflict of corporate culture*". The Merger gave corporate lawyers in Korea and also in U.S. tremendous opportunity to deepen the viewpoints regarding various problems on corporate governance and corporate finance. Still goes on in Korean Courts the appraisal proceedings and litigations in civil sector. Relating criminal proceedings are also still in going. It actually is a never ending story.

The Merger, I think, has awaken once more in the heart of Korean People the legal independency of corporation itself, in consequence that they could look back the nature of corporation and have once more a good opportunity to escape themselves from the long-lasting family-oriented structure of korean conglomerate.

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47 Licht, "The Mother of All Path Dependencies ; Toward a Cross-Cultural Theory of Corporate Governance System", 26 Delaware Journal of Corporate Law 147 (2001).

48 Gilson, "Globalizing Corporate Governance : Convergence of Form or Function", 49 American Journal of Comparative Law 329 (2001).

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Recoupment Patent

Miriam Marcowitz-Bitton *

ABSTRACT

The patent system aims to encourage innovation while keeping its own administrative costs to a minimum. Considering the centrality of innovation to 21st century economic activity, patent law is widely viewed as a crucial element of our legal system. And yet by any standard our patent system is broken. At present it encourages the filing of a plethora of low-quality patents that have no true innovative value, is plagued by opportunistic patent trolls, and produces endless amounts of costly litigation.

This article demonstrates how these phenomena are due to central design flaws in the current system. First, although the patent system is designed to encourage investment in innovation, it lacks a mechanism for directly examining an inventor's level of investment. This major flaw systematically ignores the single most important factor the patent system seeks to promote. Second, the current system offers one-size-fits-all protection, granting the same 20-year monopoly to any and all inventions. This inflexible legal standard is outdated and inappropriate, given the wide variety of inventions it addresses and the immense differences between them.

The core of this article proposes structural reform designed to remedy these fundamental flaws. First, we suggest that the patent system must explicitly consider the investment made in each specific invention when deciding what level of legal protection each invention merits. Second, we advocate departure from the current one-size-fits-all model in favor of a more tailored approach, offering different periods of protection for different inventions. These two elements would produce a system in which inventions are granted protection for a duration that depends on the level of investment each invention requires. We call this model a "recoupment patent" and highlight its advantages over the current system.

Under the new model, filing for patent protection will require documentation of investment in the invention, which will serve as the basis for determining duration of protection. Protection will expire once the investment is recouped and a fixed percentage of profit is earned. Filing and renewal fees will also be calculated based on documented investment. Additionally, investment will serve as a basis for calculating royalties (or damages in subsequent litigation). In either case, the patentee bears the burden of demonstrating the level of investment in the invention. This regime is more accurately tailored to incentivize innovation while avoiding the excessive protection that results from the current one-size-fits-all system. This new regime also incorporates mechanisms to prevent inventors from misstating their investment. Throughout the paper, we address the challenges created by our proposal and highlight its advantages over the existing system and over other reform proposals. We also discuss extensions

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and possible refinements to the basic conception outlined above.

KEYWORDS: intellectual property, patent, NPE, law reform, patent trolls, innovation

Table of Contents

I. INTRODUCTION

The patent system has been under fire in recent years, with critics highlighting its major flaws and negative effects on innovation.[1] *First*, patents are currently of undisputed low quality.[2] Low patent quality means that many

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[1] *See generally* JAMES BESSEN & MICHAEL J. MEURER, PATENT FAILURE: HOW JUDGES, BUREAUCRATS, AND LAWYERS PUT INNOVATORS AT RISK (2008) (showing that while patents provide incentives to invest in research, development, and commercialization, for most businesses today, patents fail to provide predictable property rights); DAN L. BURK & MARK A. LEMLEY, THE PATENT CRISIS AND HOW THE COURTS CAN SOLVE IT (2009) (showcasing the existence of a patent crisis, where patents calibrated to the needs of the pharmaceutical industry are not able to accommodate information technologies, and vice versa, and suggesting that courts should use industry specific rules to provide an appropriate level of incentive for each industry).

[2] *See* R. Polk Wagner, *Understanding Patent-Quality Mechanisms*, 157 PA. L. REV. 2135, 2140

patents offer protection for negligible technological developments, which are close to being obvious, or that were created with little to no effort. Such low quality patents offer owners the same level of protection as do high quality patents, barring non-owners from utilizing many technological advancements. Low quality patents thus hinder innovation and progress rather than promote them.[3] When patents are generally of low quality, substantial uncertainty will attend their validity, scope, and enforcement, imposing heavy costs on those who make decisions based on patents, such as patentees, prospective licensees, investors, and others.[4] Additionally, "a system of low quality patents is characterized by a large number of errors in the patent granting process."[5] In addition to inappropriate grants, inappropriate denials of patentable inventions can be a disincentive for future researchers and the full commercialization of important innovations.[6] Finally, the most apparent consequence of low quality patents relates to its impact on litigation.[7] The uncertainty that surrounds low quality patents increases litigation and promotes more complex and expensive disputes, which increases the costs of the entire system.[8] It is no surprise that the demand to improve patent quality is the centerpiece of many current calls for patent reform.[9] Scholars have previously suggested that the problem of low quality patents is especially pronounced in the context of business method and software patents, and patent quality in these areas is hotly debated.[10] To date, discussions have yielded many proposals for reform, some of which have been wholly or partly adopted.[11] However, these types of patents still threaten general patent quality.[12]

Second, "patent trolling" offers another major challenge to the current patent system.[13] It is associated with the generation of income, not through

(2009) (discussing the decline in patent quality).

3 *Id.* at 2140 (explaining the problems raised by low quality patents).

4 *Id.* (summarizing the costs of low quality patents).

5 *Id.* at 2141.

6 *Id.* (considering the ramifications of improperly denying patent applications).

7 *Id.* at 2142 (observing the correlation between litigation and low quality patents).

8 *Id.* at 2141-43 (discussing the effects of low quality patents).

9 *Id.* at 2136 (citing sources discussing patent reform). Most efforts and proposals in this context view patent quality as mainly an administrative concern, *id.* at 2158-61 (discussing the administrative changes that patent reform is focused on). Other proposals focus on reforming the prosecution process, *id*. at 2162 (describing the proposed prosecution focused patent reform).

10 *See* BESSEN & MEURER, *supra* note 1, at 187-214 (discussing software and business method patents).

11 BURK & LEMLEY, *supra* note 1, at 4-5, 100-08 (discussing patent reform initiatives).

12 *See* BESSEN & MEURER, *supra* note 1, at 21-24 (discussing the problematic nature of software patents).

13 The term "patent troll" is attributed to Peter Detkin. Detkin defined a "patent troll" as "somebody who tries to make a lot of money off a patent that they are not practicing and have no intention of practicing and in most cases never practiced." *See* Brenda Sandburg, *You May*

commercialization, but through aggressive licensing and litigation of patents by non-practicing entities (NPEs).[14] While encroaching upon the constitutional mandate to "promote the progress of science and useful arts," patent trolls divert investment from research and development to potentially unwarranted licensing fees or litigation.[15] Patent trolling is often facilitated by the granting of low quality patents that cover overly broad claims.[16] "By asserting overbroad, obvious, or non-novel patents…patent trolls often force alleged infringers to choose between paying licensing fees for a patent that they believe is invalid or facing costly and protracted litigation."[17] Unfortunately, the current regime tolerates patent trolling.[18] The Patent Act does not require that inventors "manufacture, sell, or market their writings or ideas" in exchange for patent protection,[19] but affords patentees exclusive rights over their inventions without demanding that they exploit their inventions to the benefit of the public in return.[20] Additionally, it does not impose any limitation on the ultimate price of licensing that patent owners may demand. The moment a patent is issued, its owner is afforded an unlimited right to exploit it for her own narrow financial benefit.[21]

Many scholars have perceived these challenges as a "patent crisis" or "patent failure", insisting on a comprehensive reexamination of the current system.[22] These challenges introduce significant costs for patentees, innovation, and society at large.[23] Scholars and policy-makers have made

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Not Have a Choice. Trolling for Dollars, THE RECORDER (July 30, 2001) (defining patent troll).

14 *See* Sandburg, *supra* note 13 (criticizing lawyers that file patent infringement claims against companies).

15 U.S. CONST. art. I, § 8, cl. 8 (providing that authors and inventors have exclusive rights to their respective works).

16 Susan Walmsley Graf, *Improving Patent Quality Through Identification of Relevant Prior Art: Approaches to Increase Information Flow to the Patent Office*, 11 LEWIS & CLARK L. REV. 495, 498 (2007) (arguing that patent trolling is driven by issuance of poor quality patents and explaining how poor quality patents containing broad claims are used offensively to obtain licenses or bring infringement lawsuits).

17 *Id.* at 498.

18 *See* Katherine E. White, *Preserving the Patent Process to Incentivize Innovation in Global Economy*, SYRACUSE SCI. TECH. L. REP. 27, 27 (2006) (suggesting major amendments to the Patent Act in order to make patent laws more favorable to patentees and disadvantage patent trolls).

19 *Id.*

20 *Id.* (noting that manufacture and sale of products is not required under the Patent Act).

21 *Id.* (emphasizing that the exclusive rights of patent owners include their ability to demand any price for their own benefit).

22 BURK & LEMLEY, *supra* note 1, at 95-170 (concluding that courts might be more effective than Congress in achieving some patent reform, by tailoring patent law to specific industries through different policy levers and common law doctrines); BESSEN & MEURER, *supra* note 1, at 235-53 (suggesting a series of reforms to improve the notice function of patent law).

23 BESSEN & MEURER, *supra* note 1, at 46-72, 147-164 (demonstrating how patents fail to provide predictable legal boundaries to their owners); BURK & LEMLEY, *supra* note 1, at 3-6 (arguing

numerous attempts to introduce different types of reforms to address these challenges.[24] Such attempts range from providing discretion to courts to tailor protection to different technologies on a case-by-case basis,[25] to calls for a comprehensive legislative reform of the patent system,[26] and even more drastic calls to abolish the patent system and introduce an alternative regime of prizes and rewards.[27]

In this article, we attribute the failure of the patent system to fundamental design flaws in its current structure. First, the patent system does not require the patentee to prove that the invention required significant investment, or any investment at all for that matter.[28] This undermines investment in innovation, which is the primary goal of the patent system. Second, our system awards all patentees uniformly, once they meet the Patent Act threshold requirements: a twenty-year government sanctioned monopoly over their purported invention.[29] This one-size-fits-all approach is inherently unfair, because it provides the same incentives to all patentees without taking into account the value of their inventions, or the great differences in levels of investment required by different inventions.

We propose to remedy these flaws by introducing a novel regime of differential, investment-based patents. Under this new model, the patentee must prove the level of investment in each invention, and the duration of the patent will depend on that level of investment. This will establish a time frame to recoup investment and earn some level of profit. Such a regime will tailor the protection it offers patentees specifically to match the real quality of their invention. It will address the problem of low quality patents by limiting their duration or altogether refusing them protection. This regime will also prevent opportunistic behavior by patent trolls, who rely heavily on the ability to acquire cheap, low quality patents.

Our proposal also features built-in safety valves that will prevent abusive behavior by patentees. These include calculating filing and renewal fees based on the level of investment documented by the patentee. Similarly, damages

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that the current patent system is in a crisis because it does not incentivize innovation properly).

24 BURK & LEMLEY, *supra* note 1, at 100-08.

25 *Id.* at 95-166.

26 *See, e.g.* BESSEN & MEURER, *supra* note 1, at 235-52.

27 BURK & LEMLEY, *supra* note 1, at 44-45; Michael Abramowicz, *Perfecting Patent Prizes*, 56 VAN. L. REV. 115 (2003) (advocating a reward system to complement existing IP protection); Mark D. Janis, *Patent Abolitionism*, 17 BERKELEY TECH. L.J. 899 (2002).

28 A patentee needs to establish that her invention meets certain threshold requirements such as subject matter eligibility, novelty, nonobviousness, utility, and written description/enablement requirements; 35 U.S.C. §§ 101, 102, 103, and 112.

29 The term of patent rights lasts for twenty years from the date the patent application is filed, with special term extensions available if the prosecution of the patent was unreasonably delayed or if regulatory approval of a drug consumed a portion of the patent term; 35 U.S.C. §§ 154 (a)(2), (b), 155-56.

might also be partially calculated based on the patentee's level of investment. Furthermore, the article proposes a secondary option for some patentees, allowing them, in appropriate cases, to base the duration of their patents not on their investment in the invention, but on the value of its use. This alternative route is designed to offer protection for those rare inventions that have great economic value, but that did not require great investment.

The article proceeds as follows: Part II reviews the current model of patent protection, exploring the flaws of its one-size-fits-all approach. This part demonstrates that the failure of the existing system can be attributed to fundamental structural flaws. In particular, it seeks to promote investment in innovation, but never directly observes, verifies, or considers the level of such investment. We demonstrate the impracticality of this type of institutional arrangement. Part III introduces the proposed differential model: an investment-based patent regime. It discusses its characteristics and advantages, proposing safeguards to address some of the challenges such a system might create. In this part we argue that a tailored investment-based patent regime brings the patent system closer to a system of rewards and prizes, allowing inventors to recoup the investment of their invention while disincentivizing the filing of low-quality and valueless patents. Part IV discusses some counter-arguments and challenges prompted by our proposal, addressing mainly the arguably significant administrative costs necessary for the operation of our tailored system. Part V compares our model to other proposals for reform, and highlights the advantages of our proposal over those alternatives. Part VI presents the conclusion.

II. The Existing Regime and the Patent Crisis

Patents are granted to incentivize innovation.[30] They afford their owners a reward in the form of a bundle of exclusive rights over their inventions, allowing owners exclusive economic benefit.[31] Without such protection, inventors will have insufficient incentive to invest, fearing they will not be able to enjoy the fruits of their labor.[32] Patent protection is therefore necessary for

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30 *See, e.g.,* Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention, in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY 609, 609 (Princeton Univ. Press 1962).

31 35 U.S.C.§ 271 (a) (once a patent has been granted, the patent owner has the exclusive right to make, use, sell, offer for sale, or import the claimed invention into the United States).

32 *See* Christopher A. Cotropia, *"After-Arising" Technologies and Tailoring Patent Scope*, 61 N.Y.U. ANN. SURV. AM. L. 151, 168-171 (2005) (patent protection provides patentees an opportunity to invent and have exclusive control over their invention); Mark A. Lemley, *Colloquium, Ex-Ante versus Ex-Post Justifications for Intellectual Property*, 71 U. CHI. L. REV. 129, 129-30 (2004) (protecting inventor's investment in their ideas).

the advancement of human knowledge, science, and technology.[33] Yet, the social gain of enhanced innovation comes with a price. To incentivize innovation, society grants inventors exclusive ownership of their inventions.[34] This results in excessively high prices of goods subject to monopolistic patent protection, as well as consequentially low production.[35] Patent law seeks to resolve this cost-benefit tension by limiting the duration of exclusivity.[36] The current system applies a one-size-fits-all approach, according to which the same 20-year period of protection is accorded to all inventions irrespective of their value.[37] In addition to this time limitation, patent law provides statutory and doctrinal safeguards against potential imbalances in the costs *vis-a-vis* benefits of patents, such as specified requirements for patentability and the availability of compulsory licensing in special circumstances of social need.[38]

The current approach to patent protection grants equal potential protection to inventions that meet the statutory requirements of subject matter eligibility,[39] utility,[40] novelty,[41] and non-obviousness.[42] Patentees have similar exclusive rights to use, sell, offer for sale, and import patented inventions[43] for a limited period. Under the current regime, the same duration of patent protection applies to all inventions. Affording all inventors identical rights of exclusivity, without taking into account the cost of the invention, creates several problems.

First, the current system undermines the constitutional mandate on which it thrives. Article 1, Section 8(8) of the United States Constitution establishes that "the Congress shall have power… To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."[44] But the current one-size-fits-all system also protects low value/investment inventions, incentivizing research and development where they are not needed "to promote the progress of science and useful arts." More specifically, if an invention can be created at a low cost, or with virtually no cost at all, no incentive is required in order "to

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33 BURK & LEMLEY, *supra* note 1, at 8.
34 *Id.*
35 *Id.* at 68, 71.
36 *See* 35 U.S.C. § 154(a)(2) (2006).
37 *See* Abraham Bell & Gideon Parchomovsky, *Reinventing Copyright and Patent*, 113 MICH. L. REV. 231, 234 (2014).
38 35 U.S.C. § 101; Gianna Julian-Arnold, *International Compulsory Licensing: The Rationales and the Reality*, 33 IDEA 349, 349-55 (1993) (defining common compulsory license agreements).
39 35 U.S.C.USC § 101.
40 *Id.*
41 *Id.* at § 102.
42 *Id.* at § 103.
43 *Id.* at § 154(a)(1).
44 U.S. CONST. art. I, §8, cl. 8.

promote" it.[45] Similarly, as such low quality investments typically contribute very little to the "progress of science," no constitutional mandate exists to incentivize their creation.[46] As one of us has argued elsewhere, the current system occasionally issues patents whose development is not dependent on the Patent Act's pecuniary incentives.[47] Granting patent protection over inventions underlying such patents is unconstitutional in a sense, because patent protection is not needed to ensure their development.[48]

Second, a closely related issue arises from the fact that our patent system grants the same level of protection to low quality patents, thus failing to balance *ex-post* costs of short-term monopoly and *ex-ante* benefits of higher incentives for innovation.[49] The decreased competition and increased costs associated with patent monopoly thus exceed the societal benefits from increased innovation.[50]

To appreciate this point, consider the costs imposed by the current system. Economic and legal scholarship has established that patents inflict dead weight loss on society.[51] Patentees enjoy the benefit of selling the rights to their inventions at monopolistic prices, which are higher than competitive prices.[52] This prevents optimum balance between sellers and buyers associated with competitive markets. Specifically, users who value the invention at more than the competitive price but less than the monopolistic price will forgo transacting with the patentee, consequently eliminating the potential profit the patentee would have earned were she to sell her invention at a competitive price. Such forgone transactions impose a loss on both consumers and producers represented by the combined surplus the parties would have received in a

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[45] Gideon Parchomovsky & R. Polk Wagner, *Patent Portfolios*, 154 U. PA. L. REV. 1, 13-14 (2005) (without patent protection, "copiers would be able to appropriate much of the value embodied in inventions without incurring the considerable costs of research and development").

[46] U.S. CONST. art. I, §8, cl. 8. ("To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.").

[47] Maayan Perel, *Reviving the Gatekeeping Function*, 23 ALB. L.J. SCI. & TECH. 337 (2013).

[48] Indeed, in some cases, there are alternative means to promote the creation of inventions. These include the ability of self-consuming the invention for the private, commercial benefit of the inventor; the availability of alternative legal protections, such as trade secret law, that can effectively protect the intellectual creation; the possibility to publish the invention and gain sufficient honor and prestige to deem the process of invention worthwhile even without a monetary compensation; and especially, the ability to invent with a very low monetary investment which can make recouping initial inventorship costs through exclusivity unnecessary. *Id.*, at 383-387.

[49] *Id.* at 381.

[50] David S. Olson, *Taking the Utilitarian Basis for Patent Law Seriously: The Case for Restricting Patentable Subject Matter*, 82 TEMP. L. REV. 181, 193-4, 186 (2009).

[51] WILLIAM A. MCEACHERN, ECONOMICS: A CONTEMPORARY INTRODUCTION 204–05 (10th ed. 2014).

[52] *Id.*

competitive market.[53]

Under a free competitive regime, lower investment costs associated with invention would lower the price of the patent. With optimal market conditions of full transparency and low transaction costs, the competitive price of a good is reflected in its marginal cost of production.[54] In a perfect competitive market, a patentee who spent $100 in developing an invention would sell her patent for exactly $100, to cover her expenses.[55] However, thanks to the benefit of exclusivity ensured by patent protection, the patentee can sell her patent for $100,000, $100,000,000, or even more, as long as she locates buyers who are willing to pay the monopolistic price. As we have all learned from the rich literature on patent trolling and patent hold-ups, agreeing to pay excessive licensing fees is not a genuine exercise of free will, but a coerced last resort.[56] Since the current one-size-fits-all system of patent protection does not align the costs or value of an invention with ultimate patent earnings, low investment inventions impose greater dead weight losses on society. To illustrate this point, consider two patents, which are sold for $100,000 each. The investment costs associated with developing patent 'A' were $1,000, while the investment costs associated with developing patent 'B' were $50,000. This means the dead weight loss from the low-investment invention 'A' equals $99,000 and is therefore much larger compared to the deadweight loss from the high-investment invention 'B', which equals only $50,000.

Of course, costs imposed by the patent system may be justified in order to promote innovation. Thus, dead weight loss is unavoidable in monopolistic markets, but might be necessary to ensure the provision of public goods. A so-called "public good" has two related characteristics: (1) non-rivalry, which means that consumption by one person does not leave less for any other consumer, and (2) non-excludability, which is the high cost of excluding non-paying beneficiaries who consume the good. Non-excludability means that the cost of barring others from the use of the good is so high that no private profit-maximizing firm will ultimately be willing to supply it.[57] As a result, the

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53 MASSIMO MOTTA, COMPETITION POLICY 41–42 (2004).

54 Steve P. Calandrillo, *An Economic Analysis of Intellectual Property Rights: Justifications and Problems of Exclusive Rights, Incentives to Generate Information, and the Alternative of Government-Run Reward System,* 9 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 301, 304-5. (1998).

55 Importantly the analysis here refers to the sale of the patent itself, and not the sale of any product that is based on the patent. The price of such products in determined based on the marginal cost of production, and regardless of the cost of research and development required for the creation of the patent.

56 *See* Mark A. Lemley & Carl Shapiro, *Frontiers of Intellectual Property: Patent Holdup and Royalty Stacking,* 85 TEX. L. REV. 1991, 1993 (2007) (addressing threat of an injunction can enable a patent holder to negotiate royalties far in excess of the patent holder's true contribution).

57 In regard to intellectual creations, Professor Wendy Gordon identifies both an initial condition

production of public goods may be insufficient due to the relative ease and low costs of use, as compared with production. Rational producers will not expend resources to produce public goods in a competitive market when they cannot make back the cost of their investment in production. Economists refer to this problem as the "public goods problem" and suggest solving it by subsidizing the production of under-produced goods.[58] Inventions are considered public goods, and therefore monopoly protection for patent rights is meant to afford inventors the opportunity to recoup the fixed cost of invention, namely, the initial cost of inventing the goods.[59] In this way, our patent system ensures the constant "progress of science and useful arts."[60]

Indeed, to justify the grant of patent rights, the monopoly costs entailed in the dead weight loss to society must be outweighed by the social benefit of increased innovation.[61] However, with low investment and low value inventions, this balancing equation seems to collapse.[62] When the process of inventing depends on relatively low monetary expenses, the inventor is likely to invent regardless of the pecuniary incentive embedded in the right to exclude rivals from entering the market for her invention.[63] With no substantial need to recoup her costs of invention, the inventor will invent so long as the prospective invention is anticipated to increase her personal utility.[64]

Most importantly, the social costs of patents protecting low value inventions outweigh the benefits of such patents to society. If the cost of creating an invention is low, society achieves only a small gain from the fact that the patent system incentivizes an inventor to make this small investment. On the other hand, the patent system still forces society to pay a high monopolistic price for this small social benefit. The social benefit does not outweigh a monopolistic price for low cost inventions, as society effectively overpays for something it could have obtained at a low price. So long as all

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of market failure stemming from appropriability (and its consequent free-rider problem) and a subsequent condition due to the inabilities of users or other second comers to form markets once creators obtain incentives to overcome the free-rider problem. *See, e.g.*, Wendy J. Gordon, *Asymmetric Market Failure and Prisoner's Dilemma in Intellectual Property*, 17 U. DAYTON L. REV. 853, 854–59 (1992) (discussing conditions for market failure); *see also* Wendy J. Gordon, *On Owning Information: Intellectual Property and the Restitutionary Impulse*, 78 VA. L. REV. 149, 223–24, 230–38 (1992).

[58] *See* ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 108 (Denise Clinton et al. eds., 5th ed. 2008) (explaining the two distinctive characteristics of public goods).

[59] SUZANNE SCOTCHMER, INNOVATION AND INCENTIVES 36 (2004).

[60] U.S. CONST. art. I, § 8, cl. 8.

[61] Louis Kaplow, *The Patent-Antitrust Intersection: A Reappraisal*, 97 HARV. L. REV. 1813, 1824–25 (1984).

[62] Perel, *supra* note 47, at 386-7.

[63] Alan Devlin & Neel Sukhatme, *Self-Realizing Inventions and the Utilitarian Foundation of Patent Law*, 51 WM. & MARY L. REV 897, 898, 921, 951 (2009) (suggesting that there is no need for incentive when no pecuniary resources were necessary for innovation).

[64] *Id.* at 927–28.

patents receive identical statutory protection, they all generate profits for their owners. Society pays for these profits. Yet, the fact that society pays *equally* to promote *all* inventions, regardless of their respective values, clearly introduces inefficiency.

To illustrate this problem, consider the following stylized example. Assume a manufacturer requires the use of two separate patented inventions in order to manufacture its main product. The first invention, owned by Patentee A, required a significant investment of $1,000,000. The second invention, owned by Patentee B, required an investment of only $1,000. Yet, if both inventions are necessary to the manufacturer, and assuming no substitutes for either are available, the manufacturer will have to buy both at a price that has nothing to do with the initial investment required for the creation of each invention. Both patentees have the power to bar the manufacturer from producing its main product and can thus demand high monopolistic prices for the use of their patents. For instance, both patentees can demand a payment of $1,000,000 for the manufacturer's license to use their patents. This means the manufacturer's product be much more expensive for consumers than it might have been if Patentee B was not awarded patent protection.

This illustration leads to the *third* problem raised by the current one-size-fits-all system. It distorts the incentive structure, frequently making development of *valueless* inventions more profitable for inventors. In the example above, it is easy to see how profits of Patentee B, who created the less valuable invention, will be exponentially greater than those of Patentee A, who created the more socially valuable one. Both are offered the same power *vis-a-vis* the manufacturer, even though Patentee A bore a much greater investment.

If identical protection and potentially similar earning opportunities compensate for smaller and larger investments in research and development alike, rational inventors will likely minimize their investment costs and develop low value inventions.[65] This is especially true in light of currently thriving patent monetization opportunities. Owners of low value inventions can always hold up inventors downstream to maximize profit, or otherwise engage in profitable litigation practices.[66] At the same time, if enormous investments in research and development yield only small earnings, regardless of societal benefit, potential inventors will probably never invent goods and services beneficial to society.[67]

Since the current one-size-fits-all system of patent protection does not afford extra points or favorable protection for extensive investments in invention, inventors are effectively encouraged to minimize their research expenses as much as possible, consequently yielding low quality inventions.

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65 *See* Bell & Parchomovsky, *supra* note 37, at 239-40.
66 *See* Lemley & Shapiro, *supra* note 56, at 1993.
67 *See* Bell & Parchomovsky, *supra* note 37, at 240.

This, in turn, obviously reduces social welfare, as society is deprived of the benefit of high value inventions. However, were patentees awarded protection that coincides with the true value of their inventions, as we propose here, inventors would have a greater incentive to engage in complex, expensive, and most importantly valuable, inventive activities.

The *fourth* problem arising from the current one-size-fits-all approach relates to its vulnerability to abuse by manipulative players in the patent ecosystem. Allowing patent owners to obtain more licensing revenues than the true value of their patents effectively hampers the ability of downstream innovators to fully commercialize the benefit of their knowledge.[68] For instance, because all patentees enjoy similar potential to extract unlimited earnings during the twenty years of patent duration, they are free to generate income far in excess of their invention's value through injunctive threats and hold-ups. For a defendant who has already invested heavily in developing and commercializing her product, which allegedly includes an infringing feature, paying excessive royalties that do not reflect the allegedly infringed patent's economic contribution is probably the best possible way to respond.[69] Otherwise, if the patent is found to be valid and infringed, the injunction will generally be effective immediately , forcing the defendant to stop commercializing her product instantly.[70] By generating income through aggressive licensing and litigation instead of commercialization, strategic patentees, often described as patent trolls, ultimately hinder subsequent innovation at a cost to social welfare.

Yet, if what patentees were to receive for the technology they create reasonably resembled their actual contribution, improper injunctive threats and strategic hold-ups could be drastically reduced.[71] If, as we suggest here, patentees were limited to recouping what they had originally invested, plus a fixed percentage of profit, we could restrict their ability to demand excessive licensing fees and effectively control their bargaining power. Because the true value of patents will become both transparent (either the patentee's declared costs or her alternative valuation will be made publicly available) and known at time of issuance, prospective licensees could not be pressed to pay extremely unreasonable fees for the exploitation of protected inventions.[72]

A *fifth* and closely related problem is the anti-commons dynamic prevalent in the current system.[73] Generally, the problem of anti-commons refers to the

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68 *See* Lemley & Shapiro, *supra* note 56, at 1992-1993 (2007).

69 *Id.*

70 Mark A. Lemley, *Ten Things to do About Patent Holdup of Standards (And One Not To)*, 48 B.C.L. REV. 149, 153 (2007).

71 *Id*. at 155.

72 See Section III.

73 *See* Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998); BURK & LEMLEY, *supra* note 1, at 75-77 (describing

issue of over-fragmentation of property rights.[74] Thus, an anti-common is created when too many owners hold rights that allow them to exclude others from a given asset.[75] In the patent context, this is often the case when several different patents cover different elements that must be integrated in order to create one product, or if different patents cover different steps in a cumulative innovative process.[76] These anti-commons easily lead to bargaining breakdowns whenever the development of a product requires permission from the owners of two or more elements.[77] In a more specific example, anti-commons theory maps well onto DNA sequence patents.[78] Patentees have acquired thousands of patents on DNA sequences that cover specific genes or fragments of genes.[79] Any particular gene therapy is likely to require the simultaneous use of many of these patents, leading to anti-commons problems.[80] In such cases, innovation can be impeded if permission from too many patentee right-holders is required in order to produce or develop a new

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the anticommons challenges of the patent system).

[74] *See* Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 SCI. 698, 698-99 (1998). *See also* Arti K. Rai, *The Information Revolution Reaches Pharmaceuticals: Balancing Innovation Incentives, Cost, and Access in the Post-Genomics Era*, 2001 U. ILL. L. REV. 173, 192-94 (2001).

[75] BURK & LEMLEY, *supra* note 1, at 76 ("The anticommons is characterized by fragmented property rights that must be aggregated to make effective use of the property.").

[76] *Id.*

[77] *Id.* ("Aggregating such fragmented property rights entails high search and negotiation costs to locate and bargain with the many rights owners whose permissions are necessary to complete broader development. This type of licensing environment may quickly become dominated by "holdouts" that refuse to license their component unless paid to do so. Because a given project will fail without their cooperation, "holdouts" may demand a bribe close to the value of the entire project."). *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1961). *See also* Rochelle Cooper Dreyfuss, *Varying the Course in Patenting Genetic Material: A Counter-Proposal to Richard Epstein's Steady Course*, *in* PERSPECTIVES ON PROPERTIES OF THE HUMAN GENOME PROJECT 196 (2005); Lloyd Cohen, *Holdouts and Free Riders*, 20 J. LEGAL STUD. 351, 356 (1991). Different anti-commons theorists suggest that the solution to this problem is either to consolidate ownership in a single owner or to preclude patent protection altogether for certain types of inventions, particularly upstream patent research tools. *See* BURK & LEMLEY, *supra* note 1, at 77; Philippe Jacobs & Geertrui Van Overwalle, *Gene Patents: A Different Approach*, [2001] EUR. INTELL. PROP. REV. 505, 505; Arti K. Rai, *Fostering Cumulative Innovation in the Biopharmaceutical Industry: The Role of Patents and Antitrust*, 16 BERKELEY TECH. L. J. 813, 838 (2001); Robert P. Merges, *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 CALIF. L. REV. 1293 (1996).

[78] *See* Dan L. Burk, *Introduction: A Biotechnology Primer*, 55 U. PITT. L. REV. 611, 621-28 (1994).

[79] *See, e.g.,* S.M. Thomas et. al., *Ownership of the Human Genome*, 380 NATURE 387, 387-88 (1996).

[80] *See* Rebecca S. Eisenberg, *Reaching through the Genome*, *in* PERSPECTIVES ON PROPERTIES OF THE HUMAN GENOME PROJECT, at 209 (F. Scott Kieff ed., 2003).

product.[81] This problem is exacerbated under the current one-size-fits-all patent system, as the proliferation of multiple low-quality patents contributes to the creation of anti-commons in the patent system. If patent quality is improved, and, as we suggest, protection is denied to patentees that made only low investments, many anti-commons will subsequently disappear.

Sixth, a problem related to the anti-commons challenge, is the issue of patent thickets.[82] Patent thickets can be thought of as describing an extreme version of the anti-commons problem, when an accumulation of overlapping patents cover a single product in a way that can potentially choke an industry.[83] Patent thickets are naturally, and inevitably created in the current system, when different inventors make small cumulative contributions to the same product.[84] As time goes by, it becomes nearly impossible to pierce the patent thicket and secure patentee consent, which is necessary for continued innovation.[85] Our proposal, limiting patent protection for patentees who have made limited contributions to a product, offers a direct solution to this type of problem. Patent thickets are also created when patent offices err in the issuing process, unintentionally granting overlapping patents to several inventors.[86] In the current patent system, such mistakes are a byproduct of the low quality of patents and their great number, which overwhelm patent offices. Our proposal, aimed at improving patent quality, will therefore help reduce also this type of patent thickets.

III. The Proposed Model

The following discussion introduces in detail our proposed recoupment-patent regime as an alternative to the current one-size-fits-all system. Our model aims to adhere closely to the economic rationale for intellectual property protection in general, and patent protection specifically, and offers remedies to many of the challenges discussed in classical patent theories.

A. The Importance of Investment in Light of Patent Theory

This section highlights the compatibility of our proposal with leading

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81 *See* BURK & LEMLEY, *supra* note 1, at 86-89 (analyzing the anti-commons theory in the context of biotechnology and DNA sequence patents).

82 *See* generally BURK & LEMLEY, *supra* note 1, at 77-78, 89-92.

83 *See* Carl Shapiro, *Navigating the Patent Thicket: Cross Licensing, Patent Pools, and Standard Setting*, 1 INNOVATION POL'Y AND THE ECON. 119, 121 (2001).

84 BURK & LEMLEY, *supra* note 1, at 78.

85 *Id.* ("Like the anticommons problem, the patent thicket has the potential to prevent all parties from making a final product that incorporates multiple inventions.").

86 *Id.*

theories of patent law. Traditionally, the theoretical justification for the patent regime centers on incentives for innovation.[87] The current patent system incentivizes innovation by providing inventors with a 20-year period of market exclusivity, thereby allowing them to benefit from their investment. This economic rationale for patent protection suggests that in the absence of patent protection, inventors cannot prevent others from copying their inventions and that, as a result, others can exploit their work for free.[88] If inventors cannot benefit fully from their inventions, they will lack sufficient incentive to invest time, effort, and money in developing new tools and ideas.[89] Our proposal, focusing on the investment of patentees in developing their ideas and products, thus makes natural sense in light of the most basic premise of patent law theory.

Extrapolating from this basic premise, scholars have fine-tuned accounts of the intricate connection between patent protection, economic incentive, and innovation.[90] Kenneth Arrow famously argued for narrow patent protection, in order to minimize interference with competition and innovation.[91] He emphasized that patents delay downstream innovation, and therefore should be as limited as possible. This position stems from Arrow's general view, endorsing competition as the best means to spur innovation.[92] The underlying assumption here is that companies in a competitive marketplace will innovate in order to avoid losing out to a competitor, while monopolists lack such incentive. Therefore, Arrow's argument proposes limited patent protection, in order to minimize associated monopolies.[93] Our proposal complements Arrow's prescriptive argument, as it endorses narrow patents, thereby creating short-term instead of long-term monopolies when possible.

Other economists and legal scholars have offered similar theories focusing on cumulative innovation, where a final product results from one or more improvements to an initial invention.[94] Robert Merges and Richard Nelson have proposed a model that tries to allocate rights among initial inventors and

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[87] *Id.* at 68.
[88] *Id.*
[89] Another utilitarian justification for granting patents, is encouraging the disclosure of inventions that might otherwise be kept secret, *id.* at 66.
[90] *Id.* at 72-75.
[91] *See* Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention, in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY 609, 619-20 (Nat'l Bureauof Econ. Research ed., 1962), *reprinted in* 5 KENNETH J. ARROW, COLLECTED PAPERS OF KENNETH J. ARROW: PRODUCTION AND CAPITAL 104, 115-16 (1985). *See also* F. M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 660 (3d ed. 1990); Mark L. Lemley & Lawrence Lessig, *The End of the End-to-End: Preserving the Architecture of the Internet in the Broadband Era*, 48 UCLA L. REV. 925, 960-62 (2001).
[92] *See* Arrow, *supra* note 91, at 619-20.
[93] *See* Michele Boldrin & David Levine, *The Case Against Intellectual Property*, 92 AM. ECON. REV. (Paperes & Proc.) 209, 209 (2002).
[94] *See* BURK & LEMLEY, *supra* note 1, at 73-75.

those who develop subsequent improvements.[95] Their theories of “tailored incentives” recognize the importance of intellectual property rights and the incentives they offer initial inventors, as well as subsequent contributors to innovation.[96] The tailored incentives approach attends more closely to the particular allocation of rights to both initial and supplementary inventors.[97] It argues that granting patents to all will normally balance incentives correctly, but that in some cases the balance should be struck based on the relative importance of the initial invention and subsequent improvement.[98] Our proposal fits the dictates of their theory, as it allows different levels of protection to different patentees based on levels of investment involved in their contributions to the invention as a whole. Thus, in light of the complexities introduced by theories of competitive innovation, cumulative innovation, anti-commons, and patent thickets, basing patent protection on investment or value is worth exploring.

In his own theoretical writing, Ted Sichelman provides a detailed account of the different phases in the development of an invention.[99] He emphasizes that “[i]nnovation isn’t instant. It involves numerous steps, many of which are fraught with uncertainty and great expense,”[100] and identifies several major phases in the innovative process.[101] The first phase is the one where the inventor identifies a problem that needs to be solved.[102] This process can be costly and labor intensive.[103] The second phase involves the moment of conception and development of a working prototype.[104] Conception is understood as that instance of “formation in the mind of the inventor, of a definite and permanent idea of the complete and operative invention, as it is

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95 Robert P. Merges & Richard R. Nelson, *On the Complex Economics of Patent Scope*, 90 COLUM. L. REV. 839, 876-79 (1990).

96 *Id.*

97 *Id*.

98 *See* BURK & LEMLEY, *supra* note 1, at 73-74.

99 Ted Sichelman, *Commercializing Patents*, 62 STAN. L. REV. 341, 348-54 (2010). *See also* Emmett W. Eldred & Michael E. McGrath, *Commercializing New Technology* – I, RES. TECH. MGMT., Jan-Feb. 1997, at 41, 41 (“Promising new technologies are not magically transformed into products; they need to be developed to the point where they are ready for commercialization.”).

100 Sichelman, *supra* note 99, at 348.

101 *Id.* Note that the innovation process varies across industries and firms within industries. *See also* a more sophisticated account of the innovation process at OFFICE OF TECH. ASSESSMENT, U.S. CONG., INNOVATION AND COMMERCIALIZATION OF EMERGING TECHNOLOGIES 31-60 (1995), available at: http://www.fas.org/ota/reports/9539.pdf.

102 Sichelman, *supra* note 99, at 348-49. *See also* Stephen J. Kline & Nathan Rosenberg, *An Overview of Innovation*, *in* THE POSITIVE SUM STRATEGY 275, 289-94 & figs. 2-3 (Ralph Landau & Nathan Rosenberg eds., 1986) (suggesting that the first stage of innovation is identifying a need in a potential market).

103 Sichelman, *supra* note 99, at 348.

104 *Id.* at 349-51.

hereafter to be applied in practice."[105] Following conception, as long as the inventor files a patent application that offers a solution which is useful, novel, and non-obvious, the invention will qualify for patenting.[106] "In reality, there is usually no single moment of conception, but rather a series of steps that refine a potential solution."[107] Because patent law does not require a working prototype for a patent, a continuum obtains from the identification of the problem to the building of working prototype upon which the single marker of conception can be placed.[108] Once this phase is complete, usually a patent application can be filed and granted.[109] The third phase following conception and the prototype development phase is the stage of transforming a prototype into a commercial product.[110] In general, a company will undertake significant market testing to determine how to build a commercially successful product.[111] Often, the capital required for the market testing and product commercialization phase is significant.[112] However, unlike the risks and costs associated with invention, "a patent does not necessarily protect the information generated during market testing and subsequent marketing,"[113] creating an *ex-ante* disincentive to engage in these activities.[114]

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[105] *See* Burroughs Wellcome Co. v. Barr Labs., Inc., 40 F.3d 1223, 1227-28 (Fed. Cir. 1994) ("Conception is the touchstone of inventorship") (quoting Hybritech Inc. v. Monoclonal Antibodies, Inc., 802 F.2d 1367, 1376 (Fed. Cir. 1986)); *see* Christopher A. Cotropia, *The Folly of Early Filing in Patent Law*, 61 HASTINGS L. J. 65, 72 ("Conception, the first step of inventing, involves the mental formation of the complete invention.").

[106] *See* 35 U.S.C. §§ 101-03 (2000).

[107] *See* Sichelman, *supra* note 99, at 350; NATHAN ROSENBERG, PERSPECTIVES ON TECHNOLOGY 191-95 (1976) (describing "the continuum of inventive activity").

[108] *See* Sichelman, *supra* note 99, at 350-51. *See* Rosenberg, *supra* note 107, at 191-94.

[109] *See* Sichelman, *supra* note 99, at 351. This is because of the reward theory's preference for early patenting and the weak disclosure standard applied by the Patent Office. *Id. See* Cotropia, *supra* note 105, at 72-75. *But see, e.g.,* Amgen, Inc. v. Chugai Pharm. Co., 927 F.2d 1200, 1206 (Fed. Cir. 1991) (court finds conception only upon the building of a working prototype).

[110] *See* Sichelman, *supra* note 99, at 351-52. *See also* VIJAY K. JOLLY, COMMERCIALIZING NEW TECHNOLOGIES 6 (1997); TOM KELLY, THE ART OF INNOVATION 103-11 (2001) (describing the importance of prototyping to product development).

[111] *See* Sichelman, *supra* note 99, at 351-52. *See also* R.G. Cooper & E.J. Kleinschmidt, *An Investigation into the New Product Process: Steps, Deficiencies, and Impact,* 3 J. PROD. INNOVATION MGMT. 71, 75-76, & exh. 2 (1986) (finding that in a study of over 250 new product launches, 25% included a detailed marketing study and 77% of the launches included a preliminary market assessmet).

[112] *See* Sichelman, *supra* note 99, at 352. *See also* Edmund W. Kitch, *The Nature and Function of the Patent System,* 20 J. L. & ECON. 265, 277 (1977) ("[M]arketing is a major cost in innovation.").

[113] *See* Sichelman, *supra* note 99, at 352.

[114] *Id.*. *See also* Michael Abramowicz & John Duffy, *Intellectual Property for Market Experimentation,* 83 N.Y.U. L. REV. 337 (2008) (recognizing that a potential deficiency of patent law is its failure to protect "market experimentation" directly); Kitch, *supra* note 112, at 276-77 (noting that investments in development of the invention "can be large and produce information . . . that would be appropriable by competitors absent the original patent"); *cf.*

Additional phases relating to the development of inventions are distribution and product improvement.[115] Once a sale is made, the product is distributed to customers.[116] Innovative and patented distribution methods can also introduce high costs to patentees who wish to commercialize their inventions.[117] Furthermore, soon after a product is launched, the company selling the product or some different entity will invent an improvement of the invention.[118] Under patent law, often these improved products fall under the scope of the patent covering the original product, as well as qualifying for separate patent protection.[119] If a third party independent of the original patentee creates the patentable improvement, the problem of "blocking patents" arises.[120] The second patent holder is blocked from making and selling the improved product by the first patent, and the first patent holder is blocked from doing the same by the second patent.[121] If the bargaining costs are lower than the benefit of the improvement, the two patent holders would presumably come to an agreement and share the profits."[122] However, "if transaction costs are high, the improvement may never be developed."[123] This, in turn, may add additional costs to the development and commercialization of inventions.

Sichleman's description of the different stages of innovation ties into our argument in two important ways. First, it highlights the fact that a single process or product may require multiple stages of development and therefore a multiplicity of patents. If, as we suggest, patent protection should depend on the level of investment, this can help solve the problems of patent thickets and patent anti-commons that often result from this multiplicity. Second, this description emphasizes the many types of costs that inventors face, thereby stressing the need to consider such investments seriously as part of the process

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Mohanbir Sawhney et al., *The 12 Different Ways for Companies to Innovate*, 47 M.I.T. SLOAN MGMT. REV. 75-76, 81 (2006) (noting that "[i]n actuality, 'business innovation' is far broader in scope than product or technological innovation" and "takes considerable efforts and time").

[115] *See* Sichelman, *supra* note 99, at 352-54. *See also* Kline & Rosenberg, *supra* note 107, at 289 (describing the fifth stage in the innovation process as bringing new products and processes to market).

[116] Distribution includes both physical shipping methods and digital routing methods.

[117] *See* Sichelman, *supra* note 99, at 353. *See also* Carl Shapiro, *Patent System Reform: Economic Analysis and Critique*, 19 BERKELY TECH. L. J. 1017, 1034 (2004).

[118] *See* Sichelman, *supra* note 99, at 353. *See also* JOLLY, *supra* note 110, at 12.

[119] *See* Sichelman, *supra* note 99, at 353. *See also* Merges & Nelson, *supra* note 95, at 860-62.

[120] *See* Robert Merges, *Intellectual Property Rights and Bargaining Breakdown: The Case of Blocking Patents*, 62 TENN. L. REV. 75 (1994); Merges & Nelson, *supra* note 95, at 860-62 (explaining the phenomenon of blocking patents).

[121] *See* Sichelman, *supra* note 99, at 353-54. *See also* Merges, *supra* note 95, at 80.

[122] *See* Sichelman, *supra* note 99, at 354. *See also* Ian Ayres & Gideon Parchomovsky, *Tradable Patent Rights*, 60 STAN. L. REV. 863, 871-73 (2007).

[123] *See* Sichelman, *supra* note 99, at 354. *See also* Ayres & Parchomovsky, *supra* note 112, at 872 ("On the margain, the . . . fees may not leave enough profits to justify the investment in the innovation.").

of patent application and issuance.

An alternative theory is offered by Edmund Kitch, who focuses on the *ex-post* benefits of patent protection.[124] In his view, absent patent protection, an invention has no owner and therefore no one has an incentive to invest in developing it further.[125] This is a classic "tragedy of the commons," as the common property, or ownerless asset (in this case the invention) is not optimally managed.[126] "Kitch's theory strongly emphasizes the role of a single patentee in coordinating the development, implementation, and improvement of an invention."[127] By granting ownership to the patentee, patents encourage downstream investment and innovation *after* a patent is granted. This account differs from traditional economic theory of patent law, as it suggests that patent monopoly is an advantage instead of a disadvantage, and focuses on encouraging investment *ex-post*, after a patent was granted, rather than *ex-ante*, before the patent is granted.[128] Our proposal offers benefits according to this theoretical perspective as well, despite the fact that Kitch's theory is markedly different from other accounts described above and is therefore highly controversial. As we demonstrate below, our proposal includes mechanisms that allow consideration of investments occurring *after* the patent is granted, and therefore can offer advantages also under Kitch's *ex-post* theory of patent law, while not providing the patentee prohibitively strong monopoly power.

B. Two-Tier Regime for Patent Protection – Investment vs. Value

This section details our proposed model and outlines its operation. It opens by examining empirical evidence for current levels of patent investment and patent value, and the connection between them. We show that existing data indicates that investment is a good proxy for patent value and that basing patent protection on the level of investment is usually the best available means of creating a tailored patent regime. We also show that in some cases it might be possible to adjust protection according to economic value, if this is required. This section then provides a detailed account of these two alternative routes.

The starting point for our analysis is the low percentage of high-value patents in the existing system. Currently, estimations suggest that only around 10% of patents issued in the U.S. are of high economic value.[129] These

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124 Kitch, *supra* note 112, at 265 (the author offered a new theory of the patent system that he believed would "reintegrate the patent institution with the general theory of property rights.").

125 *Id.* at 276-78; Wendy J. Gordon, *Of Harms and Benefits: Torts, Restitution, and Intellectual Property*, 21 J. LEGAL STUD. 449, 473-74 (1992): Robert P. Merges, *Of Property Rules, Coase, and Intellectual Property*, 94 COLUM. L. REV. 2655, 2660-61 (1994).

126 BURK & LEMLEY, *supra* note 1, at 69-72.

127 *Id.* at 71.

128 *Id.* at 69.

129 *See* BESSEN & MEURER, *supra* note 1, at 95-119 (reviewing empirical data pertaining to U.S.

estimations are based on licensing fee data.[130] Renewal at the 12-year mark is another indicator of high-value patents. Patents are eligible for renewal at years 3, 7, and 11 from date of issue.[131] Current data suggest that only about 30% of issued patents are renewed in the last period.[132] Many of those that are renewed are renewed for cross-licensing purposes.[133] Thus, low-value inventions account for the great majority of issued patents.[134]

From the 10% of inventions that are considered high value, it is estimated that a small fraction reflects “spark of genius” innovations, which combine great societal value with low investment.[135] Such inventions account for approximately 5% of high value patents issued across all technologies, suggesting that only around 0.5% of all patents are the product of a spark of genius and reflect both low investment and high value.[136] In some sectors, such as business methods, or information technologies, this estimate is probably 1% of issued patents.[137]

Given these estimates, it appears that most patents issued pertain to inventions that are of low value and also require low investment to create. As we suggested above, it is unclear that these inventions need to be incentivized through the patent system in the first place. Even if they should be encouraged, there is no reason this should be through the one-size-fits-all system.

Our two-tier investment and value-based regime attempts to respond to these challenges. Under the investment-based patent regime, patent protection will be based upon the investment incurred by the patentee in creating her invention. Under this regime a patentee can get protection for a duration of time required to recoup her investment in creating the invention, as well as an additional fixed profit agreed upon in advance in order to incentivize innovation and patent filing. If patent protection aims to address the risk involved in invention, recouping investment accompanied by additional profit is arguably important for incentivizing patent filing, avoiding trade secrecy, and properly rewarding inventors.

Under the investment-based regime, patentees will continue filing for patents, as they currently do. However, instead of receiving protection for 20

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and foreign patents value and showing that “the majority of patents are not worth more than a few thousand dollars”).

130 *Id.* at 100-101.

131 *Id*. at 99-104.

132 *Id*. at 100.

133 *Id*.

134 *Id*.

135 Ted Sichelman, *Commercializing Patents*, 62 STAN. L. REV. 341, 343-44 (2010) (“[P]atent law encourages inventors to file for patents early in the innovation process. At his stage, especially for modern technologies, an invention is usually not in the form of a finished product ready for sale.”).

136 *Id*.

137 *Id.*

years, a patentee will be able to recoup her declared investment plus an additional fixed percentage of profits. The applicant will be obliged to file investment recoupment reports upon renewals, to ensure protection until she fully recoups her investment and additional fixed profits. For example, a pharmaceutical company will be able to file for its investment in developing a specific drug, recouping its high development costs, which can be as high as 2.4 billion dollars per drug, including failed attempts at development, which are currently not fully subsidized.[138] This will make the clumsy and complex existing regimes for the extension of pharmaceutical patents, due to regulatory approval delays, redundant and unnecessary.[139] Such a tailored regime will allow the company to recoup its investment while profiting, thus incentivizing companies to undertake the high costs involved in drug development. Similarly, a company engaged in developing computer software will be able to recoup its investment without receiving an excessive 20-year term of protection unnecessary to recoup its presumably lower investment.[140]

Notably, while the patent applicant will have to document actual and anticipated investment in advance and upon filing for the patent, her investment can be updated during the lifetime of the patent to reflect the patentee's actual investment. This feature of the model is critical because patent applications are usually filed at an early phase in the life of the invention,[141] in order to preempt others under the first-to-file patent regime.

The model we propose will be accompanied by various safeguards designed to prevent abuse. Under this regime, companies would arguably be incentivized to report higher investment so that they can recoup higher returns. In order to address this concern, the following safety valves will be introduced: *first*, application and renewal fees will be keyed to the declared investment. Patentees will thus be required to pay application and renewal fees that stand in relation to the level of protection they claim. Fees will be calibrated to the level of investment, to prevent abuse. This flexible method for calculating filing and renewal fees will disincentivize flawed reporting. *Second*, upon litigation and licensing of the patent, a patentee will bear the burden of proof to establish the level of investment, which will be the basis for calculating both damages and

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[138] It is estimated that the total time spent from beginning of a research project to the marketing of a successful drug is twelve to fifteen years, 1.8 years of which is due to the FDA approval process. Estimates of the average costs of drug development and testing range from $150 million to over $800 million. BURK & LEMLEY, *supra* note 1, at 204 n.1. For more recent drug development estimates *see, e.g.*, Christopher P. Adams & Van V. Brantner, *Estimating the Cost of New Drug Development: Is It Really $802 Million?*, 25 (2) HEALTH AFFAIRS 420-28 (2006); *see also* Emily M. Morris, *The Myth of Generic Pharmaceutical Competition Under the Hatch-Waxman Act*, 22 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 245 (2012).

[139] *See* BURK & LEMLEY, *supra* note 1, at 3-4, 136-37.

[140] *Id.* at 84-85 ("The software industry also has relatively low fixed costs and a short time to market.").

[141] Cotropia, *supra* note 105, at 68-70, 72-81.

royalties.[142] Such a burden will also contribute to the disincentivizing of flawed reporting. Additionally, beyond these two major safeguards, many existing schemes guarantee honest reporting of investment. For example, income state and federal tax filings,[143] SEC filings,[144] publicly traded companies' regulatory reporting schemes,[145] private companies' by-laws and reporting requirements,[146] etc., will impede false reporting. If a patentee knows that different reporting schemes will verify her statements, she will hesitate to abuse the system. This is especially valuable when we look at very high investment patents such as pharmaceutical patents. Most pharmaceutical companies and major technology companies are publicly traded,[147] so false reporting is not a real concern, especially given these additional oversight tools.

The risk of false reporting may be aggravated in the case of global corporations, because such corporations can attribute greater investment to a certain patent or attribute a certain investment to a few patent applications, especially if a recoupment model is adopted globally. Similar reporting challenges came up in the context of international taxation of global corporations with regard to transfer prices.[148] These challenges have been addressed by introducing a unified reporting scheme, which is workable and proven to be successful.[149] If our recoupment regime is adopted globally or by a large number of countries, a unified reporting scheme can be introduced and offer yet another safeguard against misstatements of investment.

Another question that must be addressed pertains to the precise definition of "investment." The proposed regime must be based on a clear understanding of what constitutes investment and why we should employ it as a measure to fix the term for patent protection. For our purposes, investment includes any expense incurred in the process of research and development of the invention, which has been described in greater detail above.[150] Such expenses can differ

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142 *See* Lisa Larrimore Ouellette, *Adjusting Patent Damages for Nonpatent Incentives*, 26 TEX. INTELL. PROP. L.J. (forthcoming 2017).

143 Tax filings require detailed reports pertaining to all expects of a company's business operation; *see e.g.*

Jeffrey A. Dubin & Louis L. Wilde, *An Empirical Analysis of Federal Income Tax Auditing and Compliance*, 41(1) NAT'L TAX J. 61 (1988).

144 On the significance of SEC filings, see Earl K. Stice, *The Market Reaction to 10-K and 10-Q Filings and to Subsequent Wall Street Journal Earnings Announcements*, 66 ACCOUNTING REV. 42 (1991).

145 On the role of such requirements, see Ray Ball, *Infrastructure Requirements for an Economically Efficient System of Public Financial Reporting and Disclosure*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 127, 127 (2001)

146 *Id.*

147 *See e.g.* David J. Denis & Atuly a Sarin, *Ownership and board structures in publicly traded corporations*, 52(2) J. FIN. ECON. 187 (1999).

148 *See generally* TSILLY DAGAN, INTERNATIONAL TAX POLICY 27-30 (2017).

149 *Id*. at 156-58.

150 *See supra* section III. A.

greatly based on the type of the technology and can vary significantly among different patenting entities (corporations, individuals, etc.). Research and development costs, as well as any other costs involved in inventing, should be taken into account. Such costs may include employee salaries, equipment and materials, lab services, consulting services, administrative costs, regulatory costs, commercialization costs, and other costs incurred while developing an invention. Investment serves as a good basis for determining recoupment, and a generally good way to protect inventors, because it is probably the only measurable variable directly relating to the invention. Investment is also very responsive to the basic economic rationale for justifying patent protection. This suggests that if patentees are afforded the ability to recoup their investment, invention will take place with proper economic incentives.

One might worry that allowing recoupment of investment might incentivize inefficient investment in research and development, because patentees know they can recoup their incurred investment regardless of their efficiency. Moreover, we might be concerned that a recoupment regime will incentivize patentees to slow down product sales, in order to extend the duration of recoupment and as a result the duration of the patent monopoly. These two concerns are not significant because patentees have a natural incentive to recoup their investment and profits as quickly as possible, especially in light of possible market competition. Therefore, there is no risk that they will try to slow the recoupment process. Moreover, patentees cannot really control the success of their products, their respective sales, and the pace of sales. Lastly, patentees will generally try to economize their costs and not overinvest in research and development, especially when they have limited knowledge regarding future income from the sales of their invention, and when they face pressure from competitors in the race to be the first to patent the invention.

One can argue that cases may occur where an invention is the product of accidental innovation, spark of genius, or other actions that do not necessarily reflect high investment of resources. There are a few possible responses to this argument. *First*, we should keep in mind that only a small fraction of high value patents results from low investment/spark of genius.[151] *Second*, even if an invention indeed represents a spark of genius, it might still be priced highly when one estimates actual dollar investments required to create it. For example, if a gifted employee comes up with an invention that is of great economic value by a spark of genius, we may assume that this employee's costs would reflect her innovative capabilities. Additionally, we can adopt a flexible measure to assess the investment in such rare cases by including employee education, training, and other contributions in the investment that can be recouped, because capacity to innovate stem from a large set of factors.

If such responses are not satisfactory, our regime offers an alternative route

[151] *See supra* section III. B.

to patentees, which can address these concerns regarding spark of genius patents: value-based patent protection. Under this route, each invention will be subject to evaluation upon approval and issuance. Evaluation will be conducted based on established schemes for the valuation of intellectual property assets discussed below. In order to guarantee objective and unbiased valuations, they may be conducted by certain agencies assigned blindly by the USPTO to each patentee. Such valuation schemes generally assess the economic value of each invention. This regime, rather than allowing a patentee to recoup her investment, allows a patentee to have her invention subject to valuation and to recoup its economic value during the life of the patent. The patentee will have to pay a fixed fee for the valuation of her invention. This approach offers the inventor a fair reward for the economic value of her invention at the time of issuance. Similar to the model proposed above regarding an investment-based approach, this scheme will also include built-in safety valves, such as filing and renewal fees which are keyed to the economic value of the invention. Note, however, that because the valuation is performed by USPTO's agency, there will not be any burden of proof regarding the assigned value, but only the need to establish the value already recouped through profits.

A two-tier investment and value-based approach will weed out many low value patents, which are arguably not the fruit of a significant investment and/or are not of high economic value. We can summarize the incentive structure created by such a regime as follows:

Invention Value	**Inventor Investment**	**Patent Filing Route**
High	High	Either investment-based or value-based filing, whichever is higher
High	Low	Value-based filing
Low	Low	Probably no filing
Low	High	Investment-based filing or no filing at all

Note that under our proposed regime, patentees will be able to choose their preferred protection route in advance. If they are highly confident about the value of their inventions, but nevertheless have incurred significant investment costs, they are likely to file for patents under the investment-based model. If, however, a patentee knows that her invention is very valuable, but the costs of inventing it are not significant or are less than the expected value, it is likely she will file under the value-based route.

We propose that payment of filing and renewal fees be deferred to a point in time when the patentee actually makes an income, rather than immediately upon filing, when the patentee does not necessarily have any income. Such an approach allows all patentees, especially entrepreneurial entities such as small startup companies with very little income, time to develop income sources that will allow them to pay the relatively high fees in turn. However, some basic fees will be paid upon filing, in order to sponsor the patent prosecution process with the USPTO.

Our proposal is centered on the U.S. market. However, it may be applied internationally and is in line with current regional and international trends calling for regional and global patent protection.[152] If applied internationally, it should be uniform and introduce a unitary reporting scheme for investment recoupment. Importantly, our proposal is aimed to offer tailored incentives. Therefore, if applied internationally, recoupment should be measured internationally. This means that if a patentee manages to recoup her investment, plus the designated level of profits in a certain country, it will not be able to apply for a patent elsewhere. If a patentee applies simultaneously for patent protection in many countries, she can recoup her investment from all of them. All patents will expire once she recoups her investment and profits. Such international investment recoupment has clear advantages over domestic recoupment. First, this means that in many cases it will not be worthwhile for patentees to file in multiple jurisdictions, thus saving significant administrative costs. Second, to maximize profits, most patentees will elect to recoup their investment in developed economies; this means that inventions will typically fall into the public domain much earlier in developing countries, thus resulting in distributional advantages and offering cheaper access to inventions.[153]

More generally, our proposal seeks to create a more balanced transaction between the inventor and the public.[154] The traditional one-size-fits-all deal is inherently unfair to high investment patentees and to the public. High investment patentees do not always get their fair share of the value of their inventions, and the public arguably pays very high costs for most inventions, even though most of them are of low value and low investment. Our two-tier regime introduces greater fairness regarding patentee's reward and incentive structures.

Importantly, under such a regime we believe we may greatly improve patent quality and resolve, or at least minimize, many of the existing challenges within the patent system. Patent quality will improve when low value patents

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[152] *See* European Patent Convention, available at: https://www.epo.org/law-practice/legal-texts/epc.html; Amir H. Khoury, *The End of the National Patent Office*, 52 IDEA, 199 (2012) (introducing a global patent while abolishing national patent protection regimes).

[153] *See* ICTSD, THE GLOBAL DEBATE ON THE ENFORCEMENT OF INTELLECTUAL PROPERTY AND DEVELOPING COUNTRIES (2009).

[154] Patent protection is perceived as a second best bargain between the public and the inventor, where the inventors provides the public with a disclosure of the invention in return for exclusivity for a limited time. *See* BURK & LEMLEY, *supra* note 1, at 66 (discussing the secondary utilitarian justification for patent law, which is encouraging the disclosure of inventions that might otherwise be kept secret).

are not filed. Additionally, the phenomenon of patent trolls might disappear or be minimized under such conditions, because such patentees will not be able to establish either high investment or the high value of their inventions. Moreover, such a regime offers important information about the costs incurred in developing the invention or about its value. Such information affords important data for licensing and litigation purposes and can greatly prevent high licensing and high litigation costs, therefore reducing information costs and transaction costs pertaining to patents filed under such regime.

One major concern is whether introducing this two-tier patent regime might incentivize inventors to rely on trade secrecy and avoid patent protection altogether. The proposed model might undermine the goal of encouraging the disclosure of inventions that might otherwise be kept secret, especially if they are of the low investment/low value type of inventions. These concerns are unrealistic, and it is unlikely that the proposed model will change existing incentives to rely on trade secrecy and patents, because the decision on which protection scheme to rely is complex and depends on many considerations.[155] When applicants can safely rely on trade secrecy, they will not file a patent application, regardless of the patent regime in place.[156] Conversely, when applicants cannot maintain secrecy they will have to apply for a patent.[157] The proposed model offers a more tailored and fair regime to all patentees and arguably removes the distortion created by the one-size-fits-all regime. If an invention is either very valuable or the fruit of significant labor, or both, the applicant will have incentives in place to apply for patent protection because she is guaranteed to recoup her investment or receive the economic value of her invention. Additionally, very few scientists obtain technical knowledge from patents and scientists at many companies are actually discouraged from reading patents.[158] Therefore, the informational value of patent documents is less significant than one would imagine.

Such an approach also incentivizes patentees to commercialize inventions and bring them to market.[159] When a patentee knows that she can recoup her investment for certain, she will have greater incentives to move forward with commercializing her invention. If we allow patentees to update their investment during the life of the patent application or the issued patent, we will see more commercialization compared to current commercialization rates, which are

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155 *See generally* David S. Levine & Ted Sichelman, *Why Do Startups Use Trade Secrets?*, 94 NOTRE DAME L. REV. 4-20, 47-51 (forthcoming 2018).
156 *See id.*
157 *See id.*
158 *See* BURK & LEMLEY, *supra* note 1, at 66.
159 *See generally* Ted Sichelman, *Commercializing Patents*, 62 STAN. L. REV. 341 (2010) (discussing the low rates of patents commercialization and proposes a new commercialization patent, granted in exchange for the commitment to make and sell a substantially novel product).

very low.[160]

C. Existing Patent Valuation Methods

This section discusses the valuation component of our proposal. The valuation of an asset is usually established via an estimation of its price, or the amount paid for it in a market exchange.[161] While the price of an asset is given in a certain, fixed monetary sum, the true value of the asset is of necessity an uncertain prediction.[162] This is especially true regarding the value of intellectual property assets.[163] Indeed, predicting the value of IP assets is especially indeterminate for a few major reasons.[164] *First*, established markets for the exchange of IP assets do not yet exist.[165] *Second*, IP assets are rarely comparable.[166] *Third*, the terms and conditions of IP exchanges vary widely, and the details of IP exchanges, especially prices, are rarely available to the public.[167] *Fourth*, there exist a "multiplicity of factors that affect a patent's value over time."[168] Thus, establishing an accurate model of patent valuation is rather elusive.[169] However, it should be pointed out that valuation of patents is a very common practice frequently undertaken by many entities.

A patent provides an exclusive right of limited duration over a new, non-obvious invention, where the right to sue others for infringement is granted in return for publication of the invention.[170] Accordingly, "the direct financial value of a patent or patent application per se, must be the value of the potential extra profits obtainable from fully exploiting the invention defined by the patent's claims in the patent's presence compared with those obtainable without patent protection."[171]

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160 *Id.* at 343-44.

161 Ted Hagelin, *Competitive Advantage Valuation of Intellectual Property Assets: A New Tool for IP Managers*, 44 IDEA 79, 80 (2003) ("[T]he valuation of an asset is an estimation of its price. The price of an asset is the amount paid for it in a market exchange.").

162 *Id.* (explaining that correlation between the estimated patent value and actual prices).

163 *Id.* (discussing why intellectual property asset valuation is more uncertain than real or personal property valuation).

164 *Id.* (providing reasons why intellectual property asset valuation is more uncertain than real or personal property valuation).

165 *Id.* (acknowledging that IP markets have not been established yet).

166 *Id.* at 80-81 (explaining why intellectual property assets are difficult to compare).

167 *Id.*

168 *See* F. Russel Denton & Paul J. Heald, *Random Walks, Non-Cooperative Games, and the Complex Mathematics of Patent Pricing*, 55 RUTGERS L. REV. 1175, 1175 (2003) (acknowledging the difficulty of establishing the value of a patent).

169 *Id.*

170 *See* Robert Pitkethly, *The Valuation of Patents: A Review of Patent Valuation Methods with Consideration of Option Based Methods and the Potential for Further Research 1-30, 2* (Judge Inst. Of Mgmt. Studies, Working Paper 21/97, 1997).

171 *Id.* at 2.

1. Rules of Thumb

Specific "rules of thumb" are often used to price patents for purposes of licensing, especially for royalty rate payments.[172] In particular, when the parties are uncertain about whether the invention can be profitably exploited, it makes sense for them to "agree to enter into a profit-sharing license rather than fix a price for the patent and engage in a sales transaction."[173] Generally, patent holders receive 5% of sales revenues or 25% of operation profit margins.[174] Another rule that is used frequently calls for a 25%/75% split of profits.[175] These rules of thumb introduce a one-size-fits-all approach that is simple and easy-to-apply.[176] On the other hand, they ignore the specific characteristics of the patent being licensed.[177] As such, this method of valuation applies a rule of profit sharing irrespective of the underlying patent's quality or potential to promote follow-on innovation.[178] As a result, such an approach cannot be the default valuation method for our value-based regime, because it does not provide a specific price tag and fails to offer a valuation of the specific patent.

2. The Cost Method

The cost method approach for valuing patents simply calculates the cost of developing and patenting the invention in question and then adds an arbitrary profit margin to that cost.[179] This method considers only historic costs of acquisition, while ignoring future benefits that may accrue from the patent and influence its value.[180] While it does consider one important indicator of patent quality – the cost of developing the underlying invention – it does so from a

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172 *See* Josh Lerner & Anne Layne-Farrar, *Valuing Patents for Licensing: A Practical Survey of the Literature* 7 (Working Paper, March 3, 2006) (describing industry practices for pricing patents).

173 *See* Denton & Heald, *supra* note 168, at 1191 (noting techniques parties can use when there is uncertainty about an invention's profitability).

174 *See* Damien Garadin & Anne Layne- Farrar, *Patent Value Apportionment Rules for Complex, Multi-Patent Products*, 27 SANTA CLARA COMPUTER & HIGH TECH. L. J. 763, 778 (2011) (noting a common rule used for valuing licensed patents).

175 *See* Lauren J. Stiroh & Richard T. Rapp, *Modern Methods for the Valuation of Intellectual Property*, 7 (1998) (describing general formulas for profit splitting).

176 *See* Lerner & Layne-Farrar, *supra* note 172, at 7 (describing one-size-fits-all approach to patent valuation).

177 *Id.* (noting the drawbacks of using the rule of thumb for patent valuation).

178 *See* Denton & Heald, *supra* note 168, at 1190 (discussing the drawback of valuation based on profit sharing regardless of patent quality).

179 *See* Lerner & Layne-Farrar, *supra* note 172, at 8 (discussing the method of valuing patents based on the cost method).

180 *See* Pitkethly, *supra* note 170, at 6 (explaining the drawbacks of the cost method of patent valuation).

positive economic perspective.[181] This cost method is the preferable approach for the investment-based route described above. However, it should be noted that under our regime, the patentee can recoup more than historic costs of acquisition as discussed in greater detail above.

3. The Market Method

This comparative pricing approach holds that "the best metric for determining the worth of a patent is the range of prices garnered in the sale of similar technologies."[182] Theoretically, this method may be more considerate of the potential economic benefit of the specific patent.[183] However, the market method assumes a positive economic point of view[184] and does not always account for the patent's quality compared to similar technologies.[185]

4. Competitive Advantage Valuation (CAV)

The major premise of the CAV method is that the value of an IP asset should be derived entirely from the value of the product, process or service that utilizes it.[186] The CAV method assumes that the value of an IP asset can be best measured by the competitive advantage that it contributes to a product, process, or service.[187] This competitive advantage is defined as the advantages or disadvantages of an asset in comparison to an average substitute IP asset.[188] Accordingly, the main variables in the CAV valuation model are the net present value of the product, process or service incorporating the IP asset and the competitive advantage contribution of the IP asset to the net present value.[189] The principles of this method are easy to understand, inexpensive, repeatable

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181 It should be noted that patent valuation can be manipulated in different ways, affecting overall patent quality. *See* Denton & Heald, *supra* note 168, at 1183 (recognizing the cost method's limitations when valuing a patent).

182 Lerner & Layne-Farrar, *supra* note 172, at 8.

183 Russell L. Parr & Gordon V. Smith, *Quantitative Methods of Valuing Intellectual Property*, *in* THE NEW ROLE OF INTELLETUCAL PROPERTY IN COMMERCIAL TRANSACTIONS 39, 55-58 (Melvin Simensky & Lanning G. Bryer eds., 1994) (analyizing the benefits of the use of the market method when valuing patents).

184 *Id.* at 58 (explaining the assumption that best efforts are used to expand application of intellectual property).

185 *Id.* (showing how uniquesness of certain patents makes using the market approach more difficult).

186 *See* Hagelin, *supra* note 161, at 81 (noting the major principle of the competitive advantage valuation method).

187 *Id.* (identifying the competitive advantage as what contributes to the value of an intellectual property asset).

188 *Id.* (explaining the competitive advantage contribution as the difference between certain asset and an average replacement).

189 *Id.* (describing the key variables in the CAV valuation method).

and scalable. It is a model which is based on a logical association of variables, while utilizing simple input values.[190]

5. The Discounted Cash Flow Method

The discounted cash flow method relies on the same kinds of calculations that financiers employ in ascribing value to other kinds of investment opportunities.[191] In particular, this method determines that the price of a patent can be expressed as the present value of the future stream of economic benefits derived from ownership.[192] It includes "projected sales of products based on the patent over its expected life or any increased share of sales as compared to competitors, net of any capital requirements of production."[193]

6. The Option Pricing Method

Another type of valuation method described in the literature is based on option valuation formulas.[194] The theory behind these methods was primarily developed for use in pricing financial options.[195] It was found applicable also to patents due to the many similarities between these two types of assets.[196] Both patents and financial options establish a future right to exploit an asset and exclude others from it.[197] The owner of a stock option has a right to obtain "an exclusive … equity interest in the underlying firm."[198] Similarly, the owner of a patent has "the right to exclude others from using the underlying invention, and further investment is required to exploit its commercial potential."[199] Additionally, financial options and patents are rights of limited duration: patents are limited by their expiration dates and options by their exercise

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190 *Id.* at 113 (concluding that CAV can be used in multiple valuation contexts).

191 *See* Lerner & Layne-Farrar, *supra* note 172, at 10 (describing the discounted cash flow method).

192 *Id.* (describing how a patent price is expressed under the discount cash flow method).

193 *Id.* (describing the challenge of separating purely economic value from other factors affecting sales and profitability; note that regardless of this method's accuracy, it is a purely economic method of valuation).

194 *See* Ariel Pakes, *Patents As Options: Some Estimates of the Value of Holding European Patent Stocks*, 54 ECONOMETRICA 755, 755 (1986) (developing a model which allows recovering the distribution returns from holding patents at each age over the lifespan of patents from information on patent renewals to enable value calculations).

195 *See* Pitkethly, *supra* note 170, at 10 (indicating the primary function of option pricing).

196 *See* Denton & Heald, *supra* note 168, at 1185 (referring to the usefulness of the market valuation method for patent valuation).

197 *Id.* at 1194 (stating that stock options and patents represent future rights to exploit and exclude).

198 *Id.*

199 *Id.*

dates.[200] Furthermore, both patents and financial options are directly linked to an underlying asset, an innovation or a firm, respectively, and both can be used to leverage or hedge against variance in prices.[201] Lastly, similar valuation challenges exist with regard to both assets in that both offer potential future earnings that cannot be priced accurately without making a complex series of economic predictions. [202]

In 1973, Myron Scholes and Fischer Black published their option valuation formula, which offered for the first time exact and prompt option pricing solutions.[203] Options on an underlying asset can be valued, according to Scholes and Black, if information exists regarding different items: the current price of the asset, the exercise price of the option, the expiration date of the option, the standard deviation of the underlying asset returns, and the risk free interest rate and the distribution function for the asset price.[204] Option pricing methods are perceived as more accurate than the previously described valuation methods. They "account for total risk, including the impact of uncertainty on the value of the patent," while providing "managers with more flexibility in evaluating the strategic possibilities entailed in licensing" a patent.[205] Yet, some scholars highlighted some of this method's shortcomings.[206]

These existing valuation methods, which evaluate patents for a range of purposes including licensing, share a few characteristics. *First*, they adopt a positive economic perspective. They estimate the future financial gains from licensing the patent under the regime of free competition. *Second*, these valuation methods are usually useful only when a patent is ripe for commercialization.[207] *Third*, these valuation methods determine a fixed licensing price,[208] which is paid either as a lump sum or as periodical royalty payments, and *fourth*, they are governed by competitive market powers.[209]

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200 *Id.*
201 *Id.* (comparing stock options to patents in relation to the underlying assets).
202 *Id.* (providing examples for valuation difficulty for patents and options).
203 *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. OF POL. ECON. 637, 640-653 (1973) (introducing a formula for pricing an option).
204 *See* Pitkethly, *supra* note 170, at 12 (highlighting the advantages of the Black & Scholes approach).
205 Lerner & Layne-Farrar, *supra* note 172, at 12.
206 *See, e.g., id.* (suggesting that one of the option-pricing method' shortcomings is lack of appropriate inputs).
207 *See* Anna Boman & Jonas Larrson, *Patent Valuation in Theory and Practice*, EKONOMISKA INSTITUTIONEN 1, 42-45 (2003) (discussing crucial factors affecting current valuation methods and noting various factors that affect licensing value).
208 *See* Lerner & Layne-Farrar, *supra* note 172, at 2-7 (examining when industry assumptions drive firms to license and how patents are ultimately licensed while noting myriad ways of payment for value of patents).
209 *See* Richard Toikka, *Patent Licensing Under Competitive and Non-Competitive Conditions*, 82 J. PAT. & TRADEMARK OFF. SOC'Y 279 (2000) (describing the impact of competitive markets on licensee's profits and overall patent value).

If a patentee chooses the value-based model for patent protection, the duration of protection will have to be limited to a certain cap on value keyed to her known investment. Otherwise, successful pioneering patents could theoretically last forever. Setting a cap on value is necessary if we want to ensure that such inventions will enter the public domain at some point in the foreseeable future. It should also be noted that, given the filing and renewal fees that are built into the two-tier model, patentees will hesitate to extend protection for long periods.

Notably, outside the context of licensing, theories of patent prizes introduce several forms of *ex-ante* patent valuation methods. The rich literature concerning patent prizes includes various suggestions on how an agency should determine, *ex-ante*, the value of the prize to be awarded to the inventor for the development of her invention as an alternative mechanism to the exclusive rights granted by patents. These valuation methods are *ex-ante* in the sense that they are applied before the invention turns into a desired commercial product, which is the case for many patents that are filed very early in the life of inventions. For example, Steven Shavell and Tanguy van Ypersele have described a prize system that inventors could opt into instead of the patent system.[210] Similarly, Michael Kremer has described a system in which patent recipients would agree to give up their patents in exchange for compensation that would be determined through a unique auction process,[211] and Doug Lichtman has suggested that the government could achieve the benefits of a prize system with much lower costs by keeping the patent system and subsidizing consumers who would value patented products above marginal cost but cannot afford them at the monopoly price.[212] Michael Abramowicz's proposal goes in a different direction and suggests that a claimant will receive her prize at a later point in time, when the true commercial potential of her invention is known.[213]

These different *ex-ante* patent prizes valuation methods create an alternative mechanism to the *ex-post* valuation methods. They provide inventors with prizes instead of exclusive rights and as such they are outside the realm of patent licensing. These valuation methods can be beneficial for our model. They can serve as a basis for an *ex-ante* valuation of patents while adopting a patent-based scheme. Prizes are desirable for many reasons.

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210 *See* Steven Shavell & Tanguy van Ypersele, *Rewards Versus Intellectual Property Rights*, 44 J.L. & ECON. 525 (2001); Calandrillo, *supra* note 54.

211 Michael Kremer, *Patent Buyouts: A Mechanism for Encouraging Innovation*, 113 Q.J. ECON. 1137 (1998).

212 Douglas Gary Lichtman, *Pricing Prozac: Why the Government Should Subsidize the Purchase of Patented Pharmaceuticals*, 11 HARV. J.L. & TECH. 123 (1997).

213 Michael Abramowicz, *Perfecting Patent Prizes*, 01-29 Law and Economics Working Paper Series, George Mason University School of Law, available at http://papers.ssrn.com/abstract=292079 (discussing the different theories of patent prizes).

However, our regime is superior to prizes in that it awards tailored patent protection, which is sponsored by the market rather than having the state step in and sponsor the prizes.

In summary, the valuation methods listed above can be used to assess the value of the patent upon approval and issuance. While the cost method is the best approach under the investment-based model, the other valuation methods can be employed by valuation agencies to assess the value of the patent under the value-based model.

D. Regulating the Process of Patent Valuation

Under our two-tier patent system, after a patent is approved, it will undergo a valuation process in which either its investment or value will be determined under the methods described above. Such determinations will provide a tool to assess the patent duration. Rather than fixing a one-size-fits-all term of 20 years from filing, under this regime the duration of the patent will be determined based on the period of time needed to recoup either investment or value. The patentee and the valuation agency will assess how much time is needed given the declared investment or assessed value. It is important to note that providing an estimate regarding the duration of each invention upfront is needed so that the innovative community has a clear sense regarding the expiration dates of such patents, as well as when they will enter the public domain, which is the engine for future innovation.[214] Our proposal suggests nominating a regulating body within the USPTO that would tag each issued patent with a price, according to the chosen route. Appointing such a regulator would ensure objectivity, predictability, stability, and proficiency in applying the proposed scheme.[215] It would also protect against price manipulations by those possessing strong bargaining power, because it provides full disclosure of information pertaining to the value of the invention or the cost of its development.

The most suitable body to implement the proposed model is the United States Patent and Trademark Office (USPTO). Under the proposed model, valuation is conducted upon approval and prior to issuance. As the entire process of patent examination is performed at the USPTO, it makes sense to

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[214] James Boyle, *The Public Domain: Forward: The Opposite of Property*, 66 LAW & CONTEMP. PROBS. 1 (2003). *See also* James Boyle, *The Second Enclosure Movement and the Construction of the Public Domain*, 66 LAW & CONTEMP. PROBS. 33 (2003) (discussing the centrality of the public domain for the production of culture and knowledge and the effects of copyright and patent policy on the public domain).

[215] *See* Michael S. Kramer, *Valuation and Assessment of Patents and Patent Portfolios Through Analytical Techniques*, 6 J. MARSHALL REV. INTELL. PROP. L. 463, 469-70 (2007) (noting that a consistent regulatory system will provide for stability).

nominate the USPTO as the body in charge of performing the valuation.[216] Additionally, because the USPTO is the governmental body responsible for examining patent applications according to the statutory requirements for patentability, it is optimally situated to execute the task of quality assessment, using eligible valuation agencies. Such assessment will be managed through a new special division of the USPTO.

Several existing valuation agencies can perform the process of patent valuation required in the proposed model.[217] The USPTO may elect a few agencies that will conduct valuations under its auspices. Applicants will have to elect a qualified agency working with the USPTO to conduct the valuation. The applicants will bear the costs of valuation. The patentee will provide the agency with information required for valuation, as well as providing its own valuation if interested. The process of assessing the investment or the value of the patent will essentially resemble the process of determining patentability: the patent applicant will be required to submit, in addition to her application and required fees, all relevant evidence that may assist the agency in determining either the investment or the value of the patent. This may include, among other factors, documentation of research and development expenses, evidence of expected commercial success, and evidence that shows the patent's anticipated use as a component or an end product. After the valuation is completed the patent will be issued and its duration will be determined based on the time needed for recouping either the investment or value determined during the valuation process. The patent owner will then have 30 days to contest this valuation and submit her opposition, paying an additional fee for such challenge. Within this period of time, the patent will remain valid. A board of appeals that consists of valuation agency members will review the opposition and issue a final patent valuation. This board's value determination will be final. It should be noted, however, that the investment route is subject to updating, as detailed above, mainly because most patents are filed early in the life of an invention before significant investment is incurred.[218]

Establishing the recommended special division may arguably impose additional administrative costs on the patent system generally and on patent applicants specifically.[219] Indeed, pursuant to the above proposal, additional costs will be introduced into the patent prosecution process. These additional

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[216] *See* Beth Simone Noveck, *"Peer to Patent": Collective Intelligence, Open Review and Patent Reform*, 20 HARV. L.J. & TECH. 123, 134-5 (2006) (explaining USPTO's resources).

[217] *See, e.g., Forbes, Top 25 Intellectual Property Valuation Firms* (2017), available at: http://consor.com/forbes-top-25-intellectual-property-valuation-service-firms/ (last visited Aug. 17, 2018).

[218] Cotropia, *supra* note 105, at 68-70, 72-81.

[219] UNITED STATES PATENT AND TRADEMARK OFFICE: 2007 ANNUAL REPORT OF THE PATENT PUBLIC ADVISORY COMMITTEE 16 (Nov. 30, 2007) (establishing the U.S. Patent and Trademark Office incur administrative costs).

administrative costs would be financed either by patent applicants, through elevated patent application fees, or by the general public through taxation.[220] Note, however, that in the long term, these heightened administrative costs may ultimately be mitigated due to the prospective decrease in low quality patent applications.[221] Indeed, since the proposed model aims to create a direct linkage between patent quality and patent value, it would presumably decrease the incentive for filing low quality patent applications, while increasing the incentive to file high quality ones.[222] Assuming it is generally harder to develop high quality inventions than low quality ones, the number of patent applications should eventually decrease.[223] Such a prospective decrease in the number of overall patent applications should, in turn, reduce the volume of human capital necessary to administer the examination process.[224] Conceivably, then, the initial increase in administrative costs should only be temporary[225] and tolerable, especially if a substantial improvement in patent quality is expected to follow.[226]

IV. Benefits and Challenges of the Model

Our two-tier patent system promotes a few objectives. *First*, it will improve overall patent quality. Bolstering the correlation between patent quality and patent protection through the two-tier system would incentivize high quality innovation, while suppressing exclusivity over low quality innovation. Additionally, the two-tier system introduces an additional screening mechanism for inventions above and beyond their current examination for patentability. Valuation can operate as a proxy to uncover inventions that are not valuable for many reasons, including obviousness, lack of novelty, lack of

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[220] Important to note, since 1990 the USPTO became fully fee funded as a result of P.L. 101-508, the Omnibus Budget Reconciliation Act (OBRA) of 1990, as amended. This means fees collected from patentees currently cover the full operational needs of the USPTO (Glenn J. McLoughlin, *U.S. Patent and Trademark Office Appropriations Process: A Brief Explanation*, CONGRESSIONAL RESEARCH SERVICE (2014) available at: https://fas.org/sgp/crs/misc/RS20906.pdf.)..

[221] *See Setting and Adjusting Patent Fees in Accordance with Section 10 of the Leahy-Smith America Invents Act*, UNITED STATES PATENT AND TRADEMARK OFFICE REGULATORY IMPACT ANALYSIS 95, 5 (Jan. 18, 2013) (suggesting that an increase in patent application fees could reduce the number of patent applications).

[222] *See id*. (analyzing the benefits of increased patent application fees).

[223] *Id*.

[224] *See id.* at 15 (concluding that an increase in the number of patent applications that are filed will necessarily bring about higher USPTO expenses on salaries and human capital).

[225] *See id.* at 5 (suggesting a three-month patent operating reserve to support sustainable funding).

[226] *See Setting and Adjusting Patent Fees in Accordance with Section 10 of the Leahy-Smith America Invents Act*, *supra* note 221, at 95 (acknowledging that potential costs to society will bring about reduced innovation and inefficient research and development).

utility, and other issues. Related to that, such system may disincentivize or minimize the effects of defensive and cross-licensing patenting, incentivizing in their place the filing of patents that allow immediate recoupment, usually inventions that are commercialized.

Second, the proposed system will reduce patent trolling. Patent trolling is associated with the generation of income by patent holders, not through commercialization, but through aggressive licensing and litigation of patent portfolios.[227] Patent trolling is fueled by issuance of poor quality patents. Therefore, improvement in patent quality should diminish its effect.

Third, such a scheme will prevent abusive acts of price manipulation. By creating limitations of the recoupment to which a patentee is eligible, either recouping her investment or value, the proposed method can stop patent owners from obtaining more licensing revenue than the investment in the process of invention or the value of their completed inventions. Once such information is publicly disclosed it will affect licensors' ability to extract excessive royalties.

Fourth, and closely related, the proposed regime will mitigate the problem of deadweight loss associated with low quality patents. Thus, low quality patents, typically characterized with low investment, will only entitle patentees to short duration protection. Therefore, patentees will only be able to sell such patents for a low price, thereby limiting the costs society has to pay for these inventions.

Fifth, such a regime will attenuate the effects of the anti-commons phenomenon as well as the effects of patent thickets. Unlike the one-size-fits-all regime, under a recoupment patent regime, the ability of patentees to extract excessive royalties and hold out will be significantly reduced, and as a result the effects of anti-commons tragedies or patent thickets will be very limited. To illustrate this, consider again the situation in which several patentees hold patent rights on different components that are necessary input for the production of a single product. Under a recoupment regime these patentees will have limited power to hold out and extort rents from the producer, as they typically will not be entitled to a 20-year period of protection for a patent that only reflects a small addition to the invention.

Sixth, this proposal will reduce litigation and related costs. An improvement in patent quality should result in more patents that meet the statutory requirements of patentability. This, in turn, will bring about greater certainty and clarity regarding patent validity and, as a result, will reduce both rates and costs of litigation.

Finally, the proposed model brings the patent system closer to a system of prizes and rewards. By tailoring protection according to the investment in the development of the invention or its value, we essentially assign greater value to high value and high investment inventions and lesser value to low value

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[227] *See supra* Part I.

inventions, thus operating in a way that resembles the way prizes and rewards would operate. While this does not provide the full advantages of prizes and rewards, such as the lack of the invention's exclusivity, our system nevertheless offers benefits that do not exist under regimes of prizes and rewards, such as avoiding the financial burden on the state that prizes and rewards would entail, and affording a more egalitarian system for rewarding innovation.

Many potential challenges to the proposed model must be addressed. *First*, unlike the relatively low administrative costs of the one–size-fits-all model, our tailored model may entail high administrative costs of two types: high costs for licensing purposes and costs stemming from patentee attempts to manipulate the system. As Louis Kaplow suggested, rewarding a more valuable invention stronger protection can entail high administrative costs.[228] Similarly, as summarized previously by Abraham Bell and Gideon Parchomovsky, one of the main arguments often raised in the literature in support of the current one-size-fits-all approach to patent protection concerns its relatively low administrative costs.[229] Specifically, some contend that the more uniform the scope of the patent protection, the less costly the process of negotiating, drafting, and policing licensing agreements.[230] Conversely, when patent rights are specific to the invention, the negotiating parties must be more precise in defining the scope of the license. Additionally, a single standard of patent protection also spares the litigation costs of third parties who seek to challenge the boundaries of protection.[231] As Bell and Parchomovsky put it, variations in patent protection mean that "courts will have to expend efforts after the fact to determine the boundaries of the different rights, and legislators will have to do the same *ex-ante*. Together, these efforts can impose substantial costs on society."[232] Additionally, the investment recoupment regime may introduce costs pertaining to manipulations of the system, such as attempts by patentees to game the system with their investment, reporting higher investment costs to their inventions. The problem can be even more significant in large and global corporations where costs can be distributed between different jurisdictions.

Nevertheless, in the long term, any increase in the costs of administering our proposed invention-tailored protection should be mitigated by an overall decrease both in the filing of extremely low value patents and in the assertion of such patents against competitors.[233] As we have shown above, the one-size-fits-all system entails many challenges and costs, and it is generally agreed that

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228 Kaplow, *supra* note 61, at 1828 (discussing the social costs of rewarding more valuable inventions stronger protection).
229 Bell & Parchomovsky, *supra* note 37, at 247.
230 Michael W. Carroll, *One Size Does Not Fit All: A Framework for Tailoring Intellectual Property Rights*, 70 OHIO ST. L.J. 1361, 1399. (2009).
231 *See id.* at 1425.
232 Bell & Parchomovsky, *supra* note 37, at 248.
233 *See infra* Section IV.

the current system is inherently unfair, that it distorts incentives for innovation, and that in the end it does not appropriately reward high value and high investment innovation. Many of the problems created by the existing system cannot be priced economically, but their negative impact on innovation is immense.[234] Moreover, many of the concerns raised may be addressed by the safeguards we have introduced, such as filing and renewal fees, reporting duties, etc. Additionally, manipulation by global corporations may be avoided by introducing uniform international reporting standards and information sharing between national patent offices, which have been effective in other contexts, such as international taxation of global corporations. Accordingly, while a tailored system is arguably more time consuming and introduces higher costs of examination and valuation, we believe these costs are not excessive, given the advantages and the cost-savings the system introduces, especially when compared to the many flaws of the current system. As we have discussed those advantages above, there is no need to repeat them here.

Second, and more specifically, our proposed system may introduce high costs for inventors in documenting investments and valuation, as well as higher filing and renewal fees. This new system may raise litigation and licensing costs if inventors have to establish their investment as a precondition to licensing or filing a lawsuit. An investment-based regime may plausibly require separate documentation for each and every invention, requiring the inventor to separate the costs introduced by each project, and attributing costs to each project when there are costs that pertain to multiple projects. However, inventors, especially corporate inventors, who file and are issued the majority of patents,[235] usually document their activities anyway, regardless of the patent regime in place. Such documentation is usually done to establish priority and credit for the invention. Therefore, it seems unlikely that the proposed regime will introduce prohibitively high costs.

Third, another popular argument in support of a one-size-fits-all approach is that it reduces information costs.[236] "The more variance there is, the greater the informational burden with which the public must contend,"[237] Bell and Parchomovsky summarize. Since patent rights apply against everyone, allowing private players to determine the scope of their rights independently allegedly raises information costs for third parties. Nonetheless, as we demonstrate, there are ways to overcome information deficiencies in invention-tailored regimes of patent protection, especially by subjecting patentees to

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[234] *See* BESSEN & MEURER, *supra* note 1,

[235] Bronwyn H. Hall, Adam B. Jaffe & Manuel Trajtenberg, *The NBER Patent Citations Data File: Lessons, Insights and Methodological Tools*, NBER WORKING PAPER SERIES 11 (2001) (corporate inventors file the majority of patents).

[236] Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 YALE L.J. 1 (2000).

[237] *See* Bell & Parchomovsky, *supra* note 37, at 249.

transparent declaration requirements, under which they must provide periodical statements of their earnings or value, and also by imposing on patentees the burden of proving their statements of incurred costs during licensing and litigation.[238]

Fourth, it can be argued that the USPTO is not the right agency to administer and enforce the proposed patent system effectively. The USPTO is arguably not equipped to estimate patent value. The examiners are overworked and spend very little time evaluating applications.[239] They also lack policy experience and as a result would face the kind of public choice problems that Congress might be better positioned to grapple with.[240] Therefore, it might be argued that it is unlikely that the USPTO can master such a recoupment regime. While such arguments are convincing with regards to the system described by scholars such as Lemley and Burk,[241] they are less convincing regarding our proposed model. The model relies more on applicant filings and reporting as well as external agencies' objective valuations and less on the USPTO's actual involvement or public choice assessment. The federal courts may play a greater role in this system, where patents granted under this regime are litigated. Courts are more suited than the PTO to operate this system's rules.

Fifth, and finally, one could argue that this two-tier model is inherently unfair, because it forces patentees to gamble at the time of filing and immediately decide on their reward scheme, even though such decisions are not necessarily possible at such an early stage. The reason for this is that the market value of the invention might not be established or known at that point, or can be subject to change, at times dramatically. Additionally, even the patentee's investment may not be fully known at the time of filing or issuance because there might be post-grant related expenses needed for further development and commercialization of the invention. While these arguments sound substantive, they are ultimately not convincing. Under the two-tier model, a patent applicant is afforded with a fair scheme that corresponds to the nature of most inventions. For most inventions, the costs incurred developing the invention are known at the time of filing. Post-grant investment can also be recouped under our model, as we allow for investment to be updated after the initial patent is granted. Therefore, allowing patentees to choose the investment-based model for recoupment provides her with a fair reward for her invention. However, the argument against the value-based scheme is stronger. It is true that an invention's value is subject to constant change.[242] However, our scheme values certainty, as well as the need to balance public interest and the sanctity of the

238 *See infra* Part IV.
239 BURK & LEMLEY, *supra* note 1, at 23-24.
240 *Id.* at 24-25.
241 *See infra* Part V.
242 *See* Denton & Heald, *supra* note 168, at 1175.

public domain against the need to incentivize innovation. The way to reach this balance is by allowing patent applicants to gamble and choose the more desirable scheme at the time of filing.

V. Advantages of the Proposed Model over Alternative Proposals for Reform

Several scholars have recently highlighted the crisis in the patent system and advanced their own proposals for reform. They contend that according all inventions the same monopolistic protection irrespective of their inherent differences results in society paying too high a price for innovation and more monopoly losses than are strictly necessary to incentivize innovation.[243] While we support this contention, we nonetheless doubt the merits of previous proposed reforms.

Bell and Parchomovsky introduced a prominent criticism of the efficacy of the current, one-size-fits-all patent system. They proposed replacing the current general regime of patent protection with one that allows patentees to choose the level of protection from a menu of options, with varying degrees of protection terms, scopes, and remedies.[244] Accordingly, patentees whose inventions portend a rather short commercial life would be able to purchase a shorter term of protection and perhaps waive their right to injunctive relief, while paying a relatively low price for their patents.[245] Such a "voluntary relinquishment of protection, either in terms of time or scope, would result in social net gain by reducing the deadweight loss associated with patent protection."[246] Importantly, the scheme proposed by Bell and Parchomovsky differentiates legal protection entirely based on the choice of the patentee. Unlike our proposal, Bell and Parchomovsky offer no connection between the duration of protection and the objective investment or value of the patent.

Unsurprisingly, it is this absolute freedom to choose their desired length and scope of protection that Bell and Parchomovsky afford patentees, and view as one of the major advantages of their proposal, which actually constitutes its main drawback. Without any objective guidelines or external review, a non-regulated, self-tailored regime of patent protection can easily miss its goals. *First*, patentees may choose to pay less for a shorter term of protection, and perhaps even give up their right to injunctive relief, but demand royalties far in excess of what they would have demanded were they automatically granted the original patent duration of twenty years. This might be done in order to

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243 *See* Bell & Parchomovsky, *supra* note 37, at 234.
244 *Id.*
245 *Id.*
246 *Id.* at 235.

maximize patentee profits during this shortened period of patent protection. In such instances, Bell and Parchomovsky's model would effectively increase rather than reduce the deadweight loss that patent protection inflicts on society.

Second, and much more importantly, for powerful patent holders and especially patent trolls, the need to pay more for broader protection may not be sufficiently threatening. With enormous potential gains from patent monetization, patentees may uniformly find it worthwhile to elect the highest rate possible in order to receive the maximal patent protection available. Patent trolls will thereby purchase high patent protection, and then use it to litigate aggressively, as they do now. In fact, because Bell and Parchomovsky's model is expected to cost them more for the same scope and length of protection they would have received under today's one-size-fits-all system, it is reasonable to assume that strategic players will pass this increase in expenses on users by raising their monetary demands. To compensate themselves for the increased price of patent protection, patentees would increase their demands for royalties during licensing negotiations, and intensify their litigation threats. In contrast to Bell and Parchomovsky's objective, this sort of strategic behavior would raise the price of patents and their respective litigation costs, while diminishing instead of enhancing social welfare. This objection seems to us sufficient to reject Bell and Parchomovsky's proposal.

Third, Bell and Parchomovsky's self-tailored regime may favor experienced, powerful patentees over small, independent inventors. The relatively high price of broader patent protection may discourage small and independent inventors from engaging in research and development in the first place. For such inventors, agreeing to a reduced patent duration or a narrower scope of protection could frustrate their ability to recoup their initial investment costs. These inventors would be consequently discouraged from engaging in any inventive activity in the first place. Hence, it may turn out that a self-tailored regime, under which patentees are free to pay for extended patent protection without any external oversight, would effectively impair the position of small inventors without having any meaningful effect on big corporations that have the financial ability to pay whatever it takes to perfect their protection.

Our proposed model succeeds where Bell and Parchomovsky's model collapses. Specifically, our investment/value-tailored system does not only differentiate between different types of inventions, correlating between the investment/value of the patent and its protection duration, but also promotes external screening. It entails a crucial component of *objectivity* that is currently missing from alternative proposals for invention-tailored protection. This element of objectivity means that patent trolls will not have the option, available to them under Bell and Parchomovsky's regime, to pay high fees for strong patent protection over low quality inventions. Under our model, when patentees elect to recoup the anticipated value of their patent rather than declare their investment costs, such value will be determined objectively, based on formal estimations of external professionals that are accepted by the USPTO. Alternatively, in cases where patentees elect to recoup their declared investment costs, the model will apply several safeguards to ensure patentees do not overstate their costs. *First*, the proposed model will make filing and renewal fees dependent on declared patentee investment. The higher the costs of investment associated with a specific invention, the higher the attached filing and renewal fees. *Second*, during licensing and litigation, patentees will bear the burden to prove that they actually accrued their declared costs. These two mechanisms will discourage patentees from providing excessive declarations of invention costs. Where patentees elect to recoup the value of their patents, such oversight is not needed as valuation is determined by an objective and independent agency rather than relying upon patentee statements.

Our proposed combination of external patent valuations with internal safeguards ensures that the investment/value model will not favor larger, more experienced corporations over small, independent inventors. Moreover, it will be able to reduce deadweight loss from patent protection effectively, as it is anticipated not only to shorten the duration of invaluable patents, but also, and even more importantly, to limit their prospective profits. Patentees who file valueless inventions will not be able to earn more than what external valuation models will allow them to earn. At the same time, inventors who invested very little resources in developing their claimed inventions will also be restricted from inflicting excessive monopoly prices on users. Such meaningful limitations over the future financial gains of worthless patents will result in a direct increase in social welfare: it will spare the excessive costs of low value patents that cannot be justified by the underlying invention's technological contribution.

Professors Dan Burk and Mark Lemley presented a different proposal for a technology-specific system of patent protection,[247] as part of the growing literature advocating technology-specific patent law to generate patent reforms.[248] Burk and Lemley suggest that courts subject different technological

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[247] Dan L. Burk & Mark A. Lemley, *Is Patent Law Technology-Specific?*, 17 BERKELEY TECH. L.J. 1155 (2002).

[248] See BESSEN & MEURER, *supra* note 1; BURK & LEMLEY, *supra* note 1, at 97; Michael Abramowicz, *Orphan Business Models: Toward a New Form of Intellectual Property*, 124 HARV. L. REV. 1362, 1406–07 (2011); Michael J. Burstein, *Rules for Patents*, 52 WM. & MARY L. REV 1747, 1761–62 (2011); Daniel R. Cahoy, *An Incrementalist Approach to Patent Reform Policy*, 9 N.Y.U. J. LEGIS. & PUB. POL'Y 587, 635–36 (2006); Michael W. Carroll, *One for All: The Problem of Uniformity Cost in Intellectual Property Law*, 55 AM U. L. REV 845, 847–49 (2006); William Fisher III, *The Disaggregation of Intellectual Property: How the Laws of Intellectual Property Have Grown—and Grown Apart*, HARV L. BULL. 24, 29–31 (2004); Eric E. Johnson, *Calibrating Patent Lifetimes*, 22 SANTA CLARA COMPUTER & HIGH TECH. L.J. 269 (2006); Amir H. Khoury, *Differential Patent Terms and the Commercial Capacity of Innovation*, 18 TEX. INTELL. PROP. L.J. 373 (2010); Jonathan S. Masur, *Regulating Patents*, 2010 SUP. CT. REV 275, 321–26 (2010); Peter S. Menell, *A Method for Reforming the Patent*

fields of invention and industries to different patent doctrines.[249] Using the software and biotechnology industries to demonstrate that patent law is effectively technology-specific in its application, Burk and Lemley argue that the application of the legal standard of the "person having ordinary skill in the art" can lead to totally different results regarding validity and scope in diverse industries. Therefore, they claim that it is important to ensure that the wide variety of different legal rules is exploited optimally in different technological contexts.[250]

While we agree with Burk's and Lemley's observations about the way courts handle patent cases in different technological fields and agree that different technological fields of invention share many common characteristics, we do not believe that *all* inventions within a specific industry are similarly valuable. A specific invention within the computer science industry can be a pioneering one, having an extremely high anticipated value, while a different computer science invention may be close to worthless. Granting both inventions equal protection imposes an excessive burden on society: the social benefit of the later invention is outweighed by the costs it imposes on competitors and the general public. As a result, society overpays for the provision of a low value patent. Additionally, because both inventions are expected to confer similar benefits on their owners, future inventors would be encouraged to invest their talent and resources in the least expensive and complicated projects, further diminishing social welfare. On the other hand, inventions in totally different industries may have similar economic value or may otherwise inflict similar costs of invention on inventors. Such inventions should merit similar patent protection, even though they pertain to different technological fields.

Furthermore, under Burk's and Lemley's model, patentees will likely try to game the system and draft their purported invention to appear to pertain to a technological field that affords better patent protection.[251] This is precisely what happened in the fields of software and business method patents.[252]

System, 13 MICH. TELECOMM. & TECH. L. REV 487, 495, 508 (2007); Peter S. Menell & Michael J. Meurer, *Notice Failure and Notice Externalities*, 5 J. LEGAL ANALYSIS 50 (forthcoming 2013), http://jla.oxfordjournals.org/content/5/1/1.full.pdf+html; Joshua D. Sarnoff, *The Patent System and Climate Change*, 16 VA J.L. & TECH 301 (2011); F.M. Scherer, *Nordhaus' Theory of Optimal Patent Life: A Geometric Reinterpretation*, 62 AM. ECON. REV. 422, 427 (1972); Frank Partnoy, *Finance and Patent Length* 12–17, 29 (U. San Diego Law & Econ. Research Paper No. 19, 2001), http://papers.ssrn.com/abstract=285144; Richard A. Posner, *Why There Are Too Many Patents in America*, ATLANTIC (July 12, 2012, 10:20 AM), http://www.theatlantic.com/business/print/2012/07/why-there-are-too-manypatents-in-america/259725/.

249 *Id.* at 1158–85.

250 *Id.*

251 *See* Bell & Parchomovsky, *supra* note 37, at 275.

252 *See* Benjamin N. Roin, *The Case for Tailoring Patent Awards Based on the Time to Market*

Because technology-specific regimes entail no means to guarantee the cooperation of patentees, they are very likely to become extremely burdensome on judges, who will have to struggle to classify the industry to which a given invention belongs. Sophisticated and experienced patentees are expected to use confusing claim drafting to receive favorable treatment, making the process of claim construction even more encumbered and time consuming than it already is.[253]

A technology-tailored system of patent protection also suffers from several practical implementation barriers. *First*, the boundaries between technologies are highly ambiguous and mutable.[254] In fact, many inventions simultaneously fall within multiple distinct technological categories.[255] *Second*, technological and market conditions evolve rapidly, further complicating the task of designing and implementing technology specific patent laws that keep pace with these changes.[256] Additionally and no less importantly, we still lack a clear and coherent analysis of how patent protection affects progress and innovation in different industries, and therefore it appears that the time is not ripe for tailoring patent awards according to technological characteristics.[257] Indeed, technological differentiation is significantly more involved than dividing between pharmaceutical and software patents. There are over 260,000 distinct categories of technology recognized by the PTO.[258] It is highly doubtful that these could ever be ranked properly according to their need for protection based solely on their technological characteristics.[259] Note, however, that we do not challenge the practice common in courts to take into account the technological field of the invention while applying different patent doctrines.

As we explain, our model clearly correlates investment/value and patent protection on a case-by-case basis. It is hence much less likely to err in

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of Inventions, 61 UCLA L. REV. 1, 35-6 (2014) (demonstrating that when courts initially prohibited pure software patents, patentees responded by drafting software claims as "computer systems" that implemented software to get around the restriction. Likewise, when the PTO created a "second look" program for business method patents to provide for a more rigorous examination process, patent applicants simply reframed their business-method claims so they could file their application in a different PTO division).

253 Wagner, *supra* note 2, at 2146 (suggesting that under the current patent regime patentees have an incentive to "draft patent applications that effectively obscure the true scope of the invention and its relationship to the prior art").

254 *See* Roin, *supra* note 252, at 32; BURK & LEMLEY, *supra* note 1, at 97-99 (2009).

255 JAE HUN PARK, PATENTS AND INDUSTRY STANDARDSJAE HUN PARK, PATENTS AND INDUSTRY STANDARDS 162–63 (2010).

256 *Id.*

257 Anna B. Laakmann, *An Explicit Policy Lever for Patent Scope*, 19 MICH. TELECOMM. & TECH.MICH. TELECOMM. & TECH. L. REVREV. 43, 45 (2012).

258 *See* USPTOUSPTO, Cooperative Patent Classification (CPC): General Introduction Into CPC, COOPERATIVE PAT. CLASSIFICATIONCOOPERATIVE PAT. CLASSIFICATION 14 (2012), http://www.cooperativepatentclassification.org/publications/UsptoUserDayGeneralIntro.pdf.

259 *See* Roin, *supra* note 252, at 34.

determining the appropriate scope of patent protection. Every invention will be examined and evaluated independently, regardless of the industry to which it belongs. Such a high degree of individualization in defining the scope of patent protection will ensure patentees do not receive more than they deserve for their specific contributions. This will subsequently guarantee that society does not overpay for worthless inventions. In addition, our model encourages the cooperation of patentees in three important ways. *First*, it requires all patentees to submit a periodical statement of earnings to allow both the USPTO and third parties to estimate the remaining patent duration.[260] *Second*, under our proposed model, filing and maintenance fees are derived either from the patentee's declared investment costs, in the case that she elects to recoup her initial investment plus a fixed percentage of profit, or the economic valuation of her patent, as determined objectively by accepted valuation agencies and tools. Therefore, any exaggeration from the side of the patentee will be reflected in the fees she will subsequently owe the USPTO. *Third*, in our model, patentees bear the burden of proving either the declared costs of their invention or their up-to-date earning, during licensing and litigation. As such, any misstatement from the side of the patentee will increase her litigation costs and possible responsibilities for damages.

A related, but more advanced proposal for a tailored system of patent awards has been advanced by Professor Benjamin Roin.[261] Noting that, "certain types of inventions take much longer to develop than others, and a lengthier time-to-market strongly correlates with an increased need for patent protection and a lower risk that patents will stifle subsequent innovation,"[262] Roin suggests differentiating between protections granted to patents in accordance with the inventions' time-to-market. This factor is arguably capable of matching need for protection with the risk of patents stifling subsequent innovation.[263] Roin defines an invention's "time-to-market" as the time it takes to move from the initial idea to its first sale as a commercialized product,[264] suggesting that this factor is an observable proxy for optimal, technology-based patent strength. At the crux of Roin's proposal stands the proposition that an invention's time-to-market strongly correlates to optimal patent strength.[265] Yet, it is possible to think about instances where worthless inventions take longer to mature into marketable goods.

According to Roin, the optimal patent award for inventions is primarily a function of their R&D costs, the risk of failure in R&D, the anticipated future

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[260] *See infra* section III.
[261] *See* Roin, *supra* note 252, at 1.
[262] *Id*. at 3.
[263] *Id*. at 8.
[264] *Id.* at 10.
[265] *Id.*

revenue streams from the projects if they succeed, and the potential for imitation by rivals.[266] Roin further argues that an invention's time-to-market is a reliable indicator for all these factors. Yet, while longer time-to-market is probably a reliable indicator of higher *commercialization* costs, we are not sure to what extent it adequately reflects the inventor's incurred costs of *invention*. An inventor does not need to provide proof of actual sales in order to secure a patent.[267] This means that her initial costs of invention may reflect only a small portion of her ultimate *commercialization* costs, which Roin generally, but with slight imprecision describes as R&D costs.[268] Moreover, according to Roin, "inventions that generate lower annual sales revenues are also likely to need stronger protection to be profitable, since it takes more time for the invention to produce enough revenue for the firm to recover its R&D costs."[269] However, extended time-to-market is obviously not the sole reason for low sales revenue. The economic value of the invention and its prospective market, the invention's technological contribution and effective consumer demand are no less, if not more important in determining the prospected annual earnings of a given patent.

Furthermore, we are not persuaded that affording stronger patent protection to inventions that take longer to reach the market is a socially desirable policy lever. Strengthening patent protection inevitably results in enhanced access barriers, which subsequently stifle innovation.[270] Consumers bear the increased deadweight loss of stronger patents and subsequent inventors are impeded from improving and advancing the strongly protected invention.[271] Arguably, providing stronger protection to patents having longer time-to-market is not the optimal way of incentivizing their provisions.

Lastly, Maayan Perel has also proposed a novel, *ex-ante* method of patent valuation for licensing purposes.[272] Very much like our proposal in this article, she suggests that the value of patents should correlate with their technological contribution to our patent system to adequately reward innovation. The

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[266] *Id.*

[267] Burk & Lemley, *supra* note 1, at 11 ("But an inventor need not have actually "reduced to practice" the invention - that is, need not have built or physically tested the claimed invention in order to file a patent application.").

[268] *See* Roin, *supra* note 252, at 88.

[269] *Id.* at 25.

[270] *See* Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention, in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY: ECONOMIC AND SOCIAL FACTORS 609, 616-7 (1962).

[271] BESSEN & MEURER, *supra* note 1, at 1-28; Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 SCI. 698, 700-01 (1998); Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law*, 75 TEX L. REV 989 (1997).

[272] See Maayan Perel, *An Ex Ante Theory of Patent Valuation: Transforming Patent Quality into Patent Value*, 14 J. HIGH TECH. L. 148 (2014).

proposed method deviates from existing methods in at least four aspects.[273] *First*, it adopts a social-normative perspective instead of a positive economic one. It essentially asks what should be the license value, from the standpoint of the patent system, and not what that value would be in a world with no regulatory intervention. *Second*, it is performed *ex-ante*, upon the grant of patent protection, long before any licensing negotiations are initiated. *Third*, it recommends flexible limitations on the ultimate license value, rather than setting a single fixed price. *Fourth*, it suggests subjecting the process of patent valuation to external regulation, instead of leaving it to the exclusive control of free market powers. Perel advances a two-step, novel method of patent valuation, determining the quality of a given patent according to proposed quality indicators and then assigning flexible price limitations that correlate with patent quality. Such a method would promote four objectives.[274] *First*, translating patent quality into a numerical patent value will encourage high quality innovation and improve patent quality. *Second*, setting *ex-ante* limitations over the licensing price the patentee may ultimately demand would downgrade patent trolling. *Third*, determining the price of a patent upon issuance will neutralize the manipulative effect of external factors, such as the identity of negotiating parties and their respective bargaining powers, as well as the circumstances surrounding licensing negotiations. As a result, such a model could hamper patentees' ability to hold up subsequent innovation and impede future research. *Fourth*, in the long term, this method would also reduce litigation costs and litigation rates for the benefit of the public as a whole. We share many of the underlying assumptions of Perel's article regarding the desirability of an *ex-ante* approach to patent valuation. However, her article is limited to licensing. Here, we present comprehensive proposals pertaining to the patent system. As such, Perel's proposal is of limited value for our purposes.

VI. Conclusion

This article proposes a novel model for patent protection, designed to overcome the epidemic of low-quality patents and the crisis it is currently creating. It introduces this scheme, with its significant safeguards, highlighting its advantages and disadvantages, and suggests that if we want to follow the wording and spirit of the constitutional mandate to incentivize innovation, we should aspire to have higher patent quality. This differentiated, invention-specific regime should be carefully designed in order to achieve its ambitious goals. The proposed scheme is the right step in that direction. The article also explores alternative schemes that have been proposed over the years as a way

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273 *Id.* at 196-235

274 *Id.* at 181-196.

to either improve or replace the system, pointing to their strengths and weaknesses. Our proposed framework offers differentiated length of patent protection, tailored according to patent investment or patent value. We demonstrate that this mechanism fits well with the dictates of patent theory and with the goals of the patent system, and therefore addresses the current patent crisis.

This promising scheme can also be applied in other fields of intellectual property law, mainly copyright law, trade secrecy, database law, and design law. It offers a thoughtful way to afford incentives, while not compromising downstream innovation. The extension of our proposed model to other fields of intellectual property should be the subject of other research projects.

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CASES

Supreme Court Decision 2018Du35025 Decided June 28, 2018【Revocation of Disposition Imposing Global Income Tax】

【Main Issues and Holdings】

[1] Where the nominal owner and the substantial owner to whom income that is subject to taxation belongs are two separate persons, the party who is liable to pay tax (held: substantial owner of income)

Whether the taxing authority bears the burden of proof regarding taxation requirements in a lawsuit seeking revocation of tax imposition (affirmative in principle)

Whether the same is applicable in cases where the disparity between nominal ownership and substantial ownership of income is a contentious issue (affirmative)

[2] Whether a nominal trust deemed a donation according to the Inheritance Tax and Gift Tax Act falls under an overseas donation that is subject to gift tax pursuant to the special provisions of Article 21 of the Adjustment of International Taxes Act (negative)

【Summary of Decision】

[1] According to Article 14(1) of the Framework Act on National Taxes, "If any ownership of income, profit, property, act, or transaction which is subject to taxation is nominal, and there is [another] person to whom such income, etc., belongs, that other person shall be liable to pay taxes and tax laws shall apply, accordingly."

In a lawsuit seeking revocation of disposition imposing tax, as a matter of principle, the taxing authority bears the burden of proving whether the relevant tax liability exists and the tax base. This holds true where it can be argued that the nominal owner and the substantial owner of transaction are separate persons.

[2] Article 21 of the former Adjustment of International Taxes Act (amended by Act No. 9914, Jan. 1, 2010) provides that a donor is liable to pay gift tax in cases where a resident donates his/her overseas property to a nonresident (*see* Parag. (1) main text). The proviso clause of the same Article enumerates and applies *mutatis mutandis* the various provisions under the Inheritance Tax and Gift Tax Act (hereinafter "Inheritance Tax Act") regarding the subject of gift tax imposition, the amount of gift tax, gift tax rate, etc. However, the provision under the Inheritance Tax Act on "nominal trust deemed a donation" absent the transfer of property without consideration is not applied *mutatis mutandis* (*see* Parag. (3)).

In full view of the language, structure, etc. of the aforementioned statutory provisions, nominal trust that is deemed a donation according to the Inheritance Tax Act ought to be regarded as not falling under an overseas donation that is subject to gift tax pursuant to the special provisions under Article 21 of the former Adjustment of International Taxes Act. Therefore, gift tax imposition against nominal trust is not possible via the application of Article 21(1) thereof.

【Reference Provisions】 [1] Article 14(1) of the Framework Act on National Taxes / [2] Article 21(1) and (3) (*see* current Article 21(4)) of the former Adjustment of International Taxes Act (Amended by Act No. 9914, Jan. 1, 2010); Article 45-2 of the Inheritance Tax and Gift Tax Act

Article 14 of the Framework Act on National Taxes (Actual Taxation)

(1) If any ownership of an income, profit, property, act or transaction which is subject to taxation, is just nominal, and there is other person to whom such income, etc., belongs, the other person shall be liable to pay taxes and tax-related Acts shall apply, accordingly.

Article 21 of the current Adjustment of International Taxes Act (Special Provisions on Assessment of Gift Tax on Overseas Donation)

(1) Where a resident donates (excluding a donation that takes effect upon the death of a donor) his/her overseas property to a nonresident, the donor is liable to pay gift tax pursuant to this Act: *Provided*, That such donor shall be exempt from gift tax when the donee is not in a special relationship, as defined in subparagraph 20 of Article 2 of the Framework Act on National Taxes, with the donor, and gift tax (including taxes substantially similar thereto) is assessed (including exemption) on the property pursuant to statutes of the relevant foreign country. *<Amended by Act No. 11606, Jan. 1, 2013; Act No. 12849, Dec. 23, 2014; Act No. 13553, Dec. 15, 2015; Act No. 14384, Dec. 20, 2016>*

(4) Article 4-2(1) and (2), 47, 53, 56 through 58, 68, 69(2), 70 through 72, and 76 of the Inheritance Tax and Gift Tax shall apply *mutatis mutandis* the assessment of gift tax under paragraph (1). *<Amended by Act No. 11126, Dec.31, 2011; Act No. 12849, Dec. 23, 2014; Act No. 13553, Dec. 15, 2015>*

Article 45-2 of the Inheritance Tax and Gift Tax Act (Deeming Property Registered in Name of Another Person to have been Donated)

(1) Where the actual owner and the title holder of any property (excluding land and buildings; hereafter the same shall apply in this Article) requiring registration, etc. to transfer or exercise a right thereto are different persons, the title holder shall be deemed to have been donated an amount equivalent to the value of such property (where the property requires change of a title, referring to the value assessed on the basis of the day on which ownership is obtained) by the actual owner as at the day on which the property is registered, etc. in the name of the title holder (where such property requires transfer of a title, referring to the day next to the last day of the year following the year in which the day on which ownership is obtained falls), notwithstanding Article 14 of

the Framework Act on National Taxes: *Provided*, That where any of the following is applicable, this shall not apply: *<Amended by Act No. 11130, Dec.31, 2011; Act No. 13557, Dec. 15, 2015>*

1. Where the property is registered, etc. in the name of another person or property title is not transferred to the actual owner who obtains ownership without any intention of avoiding taxes;

2. Deleted; *<by Act No. 13557, Dec. 15, 2015>*

3. Where registration, etc. of the fact that the property is in trust pursuant to the Financial Investment Services and Capital Markets Act is made;

4. Where a non-resident makes a registration, etc. in the name of a legal representative or administrator of the property.

(2) In applying paragraph (1), where the title holder is a profit-making corporation, the actual owner (excluding a profit-making corporation) shall pay gift tax. *<Newly inserted by Act No. 13557, Dec. 15, 2015>*

(3) Where a person registers, etc. his/her property in the name of another person, or a person does not change a name on property title to actual owner, he/she shall be presumed to have an intention of avoiding taxes: *Provided*, That where he/she does not change name on property title to actual owner and where any of the following is applicable, he/she shall not be presumed to have an intention of avoiding taxes: *<Amended by Act No. 13557, Dec. 15, 2015>*

1. Where, in cases of obtaining ownership as a result of purchase and sale of the property, the previous owner makes a report on the change of property title as he/she files a return of capital gains tax base prescribed in Articles 105 and 110 of the Income Tax Act or a return prescribed in Article 10 of the Securities Transaction Tax Act;

2. Where, in cases of obtaining ownership through inheritance, an heir files a return in which the property is included in the taxable value of inheritance as he/she files a return corresponding to any of the following; *Provided*, That where he/she files a revised return knowing beforehand that inheritance tax base and tax amount are to be determined or corrected, or files a return after deadline, such case shall be excluded herefrom:

(a) A return of the inheritance tax base prescribed in Article 67;

(b) A revised return prescribed in Articles 45 of the Framework Act on National Taxes;

(c) A return filed after the deadline prescribed in Article 45-3 of the Framework Act on National Taxes.

(4) In applying paragraph (1), where a shareholder register or an employee register has not been prepared, whether property title has been changed shall be determined with documents concerning shareholders, etc. and a report on changes in the ownership of stocks, etc. submitted to the head of a tax office having jurisdiction over the place of payment of tax prescribed in Articles 109(1) and 119 of the Corporate Tax Act. *<Amended by Act No. 13557, Dec. 15, 2015>*

(5) Deleted. *<by Act No. 13557, Dec. 15, 2015>*

(6) The term "taxes" in paragraphs (1)1 and (3) means the national tax and local tax referred to in subparagraphs 1 and 7 of Article 2 of the Framework Act on National Taxes and customs referred to in the Customs Act. *<Amended by Act No. 13557, Dec. 15, 2015>*

(7) Deleted. *<by Act No. 13557, Dec. 15, 2015>*

[This Article wholly amended by Act No. 9916, Jan. 1, 2010>

【Reference Cases】 [1] Supreme Court Decisions 2006Du6383 decided Sept. 22, 2006; 2011Du9935 decided May 16, 2014 (Gong2014Sang, 1237); 2015Du60341 decided Jun. 10, 2016 (Gong2016Ha, 955); 2015Du53084 decided Oct. 26, 2017

【Plaintiff-Appellee】 Plaintiff (Attorneys Lee Sang-woo et al., Counsel for the plaintiff-appellee)

【Defendant-Appellant】 Head of National Tax Service Banpo District Office (LCS Law, Attorneys Lee Chang et al., Counsel for the defendant-appellant)

【Judgment of the court below】 Seoul High Court Decision 2016Nu87051 decided January 11, 2018

【Disposition】 The final appeal is dismissed. The cost of the final appeal is assessed against the Defendant.

【Reasoning】 The grounds of appeal are examined.

1. Ground of appeal No. 1

A. <u>According to Article 14(1) of the Framework Act on National Taxes, "If any ownership of income, profit, property, act, or transaction which is subject to taxation is nominal, and there is [another] person to whom such income, etc., belongs, that other person shall be liable to pay taxes and tax laws shall apply, accordingly." In a lawsuit seeking revocation of disposition imposing tax, as a matter of principle, the taxing authority bears the burden of proving whether the relevant tax liability exists and the tax base. This holds true where it can be argued that the nominal owner and the substantial owner of transaction are separate persons</u> (*see*, *e.g.*, Supreme Court Decision 2011Du9935, May 16, 2014).

B. Reasoning that there is room for doubt as to whether the Plaintiff is the beneficial shareholder of the Hong Kong-based Sejee Co., Ltd. (hereinafter "Sejee"), the lower court determined that the Defendant's imposition of global income tax, premised on the fact that Sejee's income from 2006 to 2010 actually reverts to the Plaintiff, was unlawful inasmuch as the requirements for taxation were not proven. Moreover, the lower court acknowledged circumstances, such as the Plaintiff's partial intervention in the management, etc. of Sejee or its subsidiaries on the following grounds: (i) no evidence was found to deem that the Plaintiff paid the amount of USD 500,000 or contributed one's property equivalent to said amount as funding for the establishment of Sejee, or that the Plaintiff used Sejee's income for personal purposes; and (ii) likelihood of a third party, not the Plaintiff, being the beneficial shareholder cannot be ruled out.

Examining the foregoing legal doctrine and the record, the lower court did not err by either misapprehending the legal principle on the burden of proof or contradicting logical and empirical rules, as otherwise alleged in the ground of appeal.

2. Ground of appeal No. 2

A. Article 21 of the former Adjustment of International Taxes Act (amended by Act No. 9914, Jan. 1, 2010) provides that a donor is liable to pay gift tax in cases where a resident donates his/her overseas property to a nonresident (*see* Parag. (1) main text). The proviso clause of the same Article enumerates and applies *mutatis mutandis* the various provisions under the Inheritance Tax and Gift Tax Act (hereinafter "Inheritance Tax Act") regarding the subject of gift tax imposition, the amount of gift tax, gift tax rate, etc. However, the provision under the Inheritance Tax Act on "nominal trust deemed a donation" absent the transfer of property without consideration is not applied *mutatis mutandis* (*see* Parag. (3)).

In full view of the language, structure, etc. of the aforementioned statutory provisions, nominal trust that is deemed a donation according to the Inheritance Tax Act ought to be regarded as not falling under an overseas donation that is subject to gift tax pursuant to the special provisions under Article 21 of the former Adjustment of International Taxes Act. Therefore, gift tax imposition against nominal trust is not possible via the application of Article 21(1) thereof.

B. The lower court determined that the Defendant's instant disposition on the ground that nominal trust does not fall under the purview of donation as prescribed by Article 21(1) of the former Adjustment of International Taxes Act was unlawful.

Such determination of the lower court is based on the legal doctrine as seen earlier. Hence, contrary to what is alleged in the ground of appeal, the lower court did not err by misapprehending the legal principle related to Article 21 of the former Adjustment of International Taxes Act.

3. Conclusion

Therefore, the final appeal is dismissed, and the cost of the final appeal is assessed against the losing party. It is so decided as per Disposition by the assent of all participating Justices on the bench.

Justices Lee Ki-taik (Presiding Justice)
Kim Shin (Justice in charge)
Park Sang-ok
Park Jung-hwa

Supreme Court en banc Decision 2017Da242409 Decided July 19, 2018【Unjust Enrichment】

【Main Issues and Holdings】

[1] Requirements for disposition of taxation to be deemed *per se* invalid and ways to determine whether flaw in disposition of taxation are apparent and critical

In a case where: (a) there is room for dispute as to the interpretation of the statutory application in regard to legal or factual relations; and (b) the tax authority made disposition of taxation based on misapprehension of the laws and regulations at issue, whether such flaws are deemed apparent (negative)

[2] Where taxpayers claimed for tax refund, whether a claim for additional payment on refund and a claim for losses caused by delay occur concurrently (affirmative)

【Summary of Decision】

[1] **[Majority Opinion]** To consider disposition of taxation *per se* invalid, mere existence of the grounds of illegality is insufficient; instead, (a) the flaws must be in critical breach of important elements of the law and objectively apparent; (b) determination on whether flaws are apparent and critical must be made in deliberate consideration of purpose, meaning and function of the laws and regulations that serve as the grounds for the said disposition of taxation, and decided by judicial consideration of the distinctive nature of the specific case at issue. Moreover, in a case where: (a) the tax authority rendered disposition of tax by applying relevant laws and regulations on certain legal or factual relations; (b) there is no room for dispute as to the interpretation of the applicable laws and regulations, as the legal principle clearly suggested the pertinent laws and regulations cannot be applied to those particular legal or factual relations; (c) nonetheless, the tax authority applied the said laws and regulations to make tax disposition, such flaws are deemed apparent and critical. However, where there is room for dispute as to the interpretation of the application of laws and regulations in regard to the legal or factual relations at issue, the tax authority's tax disposition by misinterpreting the laws and regulations is simply a result of an erroneous acknowledgement of the facts regarding taxation requirements; hence, the flaws cannot be deemed apparent.

[Dissenting Opinion by Justice Kim Shin, Justice Kim Jae-hyung, and Justice Park Jung-hwa] Where there is room for dispute as to the interpretation of the laws and regulations regarding a tax obligation, the imposition, report, and payment of tax on the basis of such laws and regulations are in breach of the principle of no taxation without representation, whose effect and legitimacy defy easy recognition.

Where (a) there are critical flaws of misinterpretation of the laws and regulations regarding a tax obligation; (b) and, as a result, tax was levied and paid by a taxpayer despite not having tax liability for that particular tax item; (c) failure to recognize invalidity of such taxation disposition constitutes transfer of disadvantage, caused by misconstruction of relevant laws and regulations, to taxpayers instead of the tax authority, which is unreasonable.

In a case where: (a) the tax authority made taxation disposition based on the interpretation of relevant laws and regulations in regard to certain legal or factual relations; (b) but it was later confirmed that the pertinent legal principle was erroneous, and thus the said taxation disposition lacked legitimacy; (c) the State is obliged to rectify such disadvantage by providing adequate remedy. If the State fails to provide such remedy or restricts remedial measures, refuses a tax refund, and enjoys the benefits accrued therefrom, the State acts in violation of the purpose of its existence, protector of the people's rights and property.

Even when: (a) considering that the flaws in taxation disposition must be critical and apparent in order to be acknowledged as invalid; (b) where the Supreme Court rendered a decision confirming that the legal principle applied to taxation disposition was derived from misinterpretation and application of the laws on taxpaying obligation; (c) the said flaws cannot be deemed the grounds for invalidity citing the lack of apparentness requirements until before the said decision was rendered.

As seen above, in a case where tax, set higher than the legitimate amount, was imposed and paid as a result of misinterpretation and application of the laws regarding taxpaying obligation, the flaws in the said tax disposition should be deemed invalid.

[2] A tax refund constitutes unjust enrichment, which is either received or retained by the State without legal grounds, despite the nonexistence or of tax liability at the outset or the lapse of such liability, whereas an additional refund is characterized as statutory interest on the unjust enrichment therefrom. The obligation to return unjust enrichment is an obligation with no fixed time limit, and thus a beneficiary is obliged to compensate any and all losses caused by delay in the performance of obligation following the day after receiving a claim for performance. Therefore, after the filing of a claim for the performance of obligation to refund tax money, a claim for additional payment on refund and a claim for losses caused by delay occur concurrently, one of which can be exercised by taxpayers at will.

【Reference Provisions】[1] Article 51 of the Framework Act on National Taxes; Article 741 of the Civil Act [2] Articles 51 and 52 of the Framework Act on National Taxes; Articles 387(2), 390, 397(1) , 741 and 748 of the Civil Act

Article 51 of the Framework Act on National Taxes (Appropriation and

Refund of National Tax Refund)

(1) If a taxpayer erroneously paid or overpaid national taxes, additional dues or disposition fees for arrears, or if there is an amount of tax to be refunded under tax-related Acts (when any amount of tax is to be deducted from the refundable amount under the tax-related Acts, referring to the remaining amount after deduction), the head of a tax office shall immediately determine such amount of erroneous payment, overpayment, or refundable amount as a refund of national tax. In such cases, any claim filed for the refund of any tax due to erroneous or double payment shall be governed by Presidential Decree.

(2) The head of a tax office shall appropriate the amount determined as refundable amount for the payment of national taxes, additional dues or disposition fees for arrears that fall under any of the following subparagraphs, as prescribed by Presidential Decree: Provided, That the appropriation of national taxes under subparagraph 1 (excluding cases falling under the cause for collection prior to the due date for payment under Article 14 of the National Tax Collection Act) and subparagraph 3 shall be made only if the taxpayer consent to the relevant appropriation: *<Amended by Act No. 10405, Dec. 27, 2010>*

1. National taxes to be paid by a notification of tax payment;
2. National taxes, and additional dues, that are in arrears, and disposition fee for arrears (including national taxes, additional dues and disposition fees for arrears in other tax offices);
3. National taxes to be paid voluntarily under tax-related Acts.

(3) Where appropriation is made under paragraph (2) 2, national taxes, additional dues, disposition fees for arrears, and refund of the national taxes shall be deemed to have become extinct in the equal amount, retroactive to the statutory due date of national taxes in arrears or the occurrence date of refund of national taxes prescribed by Presidential Decree, whichever is the later date. *<Newly Inserted by Act No. 10405, Dec. 27, 2010>*

(4) Where a taxpayer is entitled to tax refund under tax-related Acts, the taxpayer may request that such tax amount be appropriated for the payment of national tax under paragraph (2) 1 and 3. In such cases, it shall be deemed that national tax is paid when the taxpayer requests such appropriation.

(5) Where a withholding agent has any tax refund from the amount of tax paid after having it withheld at source, he/she shall be paid the remainder of taxes that the person appropriates for the payment of the amount of taxes payable by withholding taxes at source (appropriation of tax refund for the payment of withholding tax on any other taxable item may be allowed only when a report on processing status of tax withholding under the Income Tax Act includes details of appropriation and adjustment thereof): *Provided*, That in the event that the withholding agent claims immediate refund of taxes or has no amount of tax to pay by withholding taxes at source, the amount of

taxes shall be immediately refunded.

(6) The amount of national tax refund remaining after appropriating under paragraph (2) shall be repaid to the taxpayer within 30 days after the refund of the national tax is determined, as prescribed by Presidential Decree.

(7) The repayment of the national tax refund under paragraph (6) shall be made by the Bank of Korea with revenues under the jurisdiction of the head of a tax office concerned, as prescribed by Presidential Decree.

(8) When the head of a tax office requests the return of the amount which has been already appropriated or paid upon revocation of the determination on refund of national tax, the provisions of the National Tax Collection Act concerning the notification, demand and disposition for arrears shall apply *mutatis mutandis.*

(9) Notwithstanding paragraph (1), in cases falling under the main sentence of Article 47-4 (6), paragraph (1) shall not apply. *<Newly Inserted by Act No. 11124, Dec. 31, 2011; Act No. 14382, Dec. 20, 2016>*

[This Article Wholly Amended by Act No. 9911, Jan. 1, 2010]

Article 52 of the Framework Act on National Taxes (Additional Refund of National Taxes)

When the head of a tax office appropriates or pays a national tax refund under Article 51, he/she shall add, to the national tax refund, the amount calculated according to the interest rate prescribed by Presidential Decree (hereinafter referred to as "additional refund of national tax") taking into consideration the period between the reckoning day of additional refund of national taxes prescribed by Presidential Decree and the day of appropriation or decision on payment, and the interest rate, etc. of deposits in financial institutions.

[This Article Wholly Amended by Act No. 11124, Dec. 31, 2011]

Article 387 of the Civil Act (Time for Performance and Delay of Performance)

(2) If a time for the performance of a claim is not fixed, the obligor shall be responsible for the delay as from the time when demand for performance has been made upon him.

Article 390 of the Civil Act (Non-performance of Obligations and Compensation for Damages)

If an obligor fails to effect performance in accordance with the tenor and purport of the obligation, the obligee may claim damages: *Provided,* That this shall not apply to where performance has become impossible and where this is not due to the obligor's intention or negligence.

Article 397 of the Civil Act (Special Rules as to Non-performance of Monetary Debt)

(1) The amount of damages for non-performance of a monetary debt shall be determined by the legal rate of interest: *Provided,* That where there exists an agreed rate of interest which does not exceed the limitation provided

by statutes, that agreed rate of interest shall prevail.

Article 741 of the Civil Act (Definition of Unjust Enrichment)

A person who without any legal ground derives a benefit from the property or services of another and thereby causes loss to the latter shall be bound to return such benefit.

Article 748 of the Civil Act (Amount of Benefits to be Returned by Person Enriched)

(1) The person enriched in good faith shall be liable to act as set forth in Article 747 to the amount that he still possesses of such benefits.

(2) A person enriched in bad faith shall return the benefits received by him together with interest, and if there has been any damage, he shall be bound also to make compensation.

【Reference Cases】 [1] Supreme Court Decisions 2006Da1633 decided Mar. 27, 2008 (Gong2008Sang, 603); 2011Da103809 decided Dec. 26, 2013 / [2] Supreme Court Decision 2009Da11808 decided Sept. 10, 2009 (Gong2009Ha, 1627)

【Plaintiff-Appellee-Appellant】 Korea Investment & Securities Co., Ltd (Attorneys Jang Ki-tae et al., Counsel for the plaintiff-appellee-appellant)

【Defendant-Appellant-Appellee】 Republic of Korea (Law Firms Hankyul et al., Counsel for the defendant-appellant-appellee)

【Judgment of the court below】 Seoul High Court Decision 2016Na2070643 decided June 9, 2017

【Disposition】 All appeals are dismissed. The cost of appeal is assessed by each party.

【Reasoning】 The ground of appeal is examined.

1. Procedural history of the case

A. From November 16, 2009 to November 16, 2015, the Commissioner of the Yeongdeungpo District Tax Office imposed a comprehensive real estate tax for the tax years of 2009 and/or 2015 on the Plaintiff (hereinafter referred to as “instant disposition”). The Plaintiff paid all the comprehensive real estate tax imposed *supra*.

B. Articles 9(3), 14(3) and 14(6) of the Gross Real Estate Tax Act prescribes that a certain amount of money constituting the tax levied as property tax (hereinafter “the amount of exempted tax”) be exempted from the amount of comprehensive real estate tax, for those housing subject to comprehensive real estate tax. In determining the amount of chargeable comprehensive real estate tax, the instant disposition took tax deduction by calculating the tax exemption amount. The amount of exempted tax was calculated by using a formula stated in the Enforcement Rule of the Gross Real Estate Tax Act under Article 5(2) [Attachment 3] [Table 2] (hereinafter “instant formula in the

Enforcement Rule”), which is: [(Clean price of taxable residential home, etc. – tax base amount) × (fair market value rate of comprehensive real estate tax × fair market value rate of property tax) × property tax rate].

C. In the meantime, Articles 4-2, 5-3(1) and (2) of the former Enforcement Decree of the Gross Real Estate Tax Act (amended by Presidential Decree No. 26670, Nov. 30, 2015), which was in force at the time of the instant disposition, provided the equation to calculate the amount of exempted tax (hereinafter “instant equation in the Enforcement Decree”), which was determined as follows: [the aggregate tax amount imposed as property tax on housing × the amount equivalent to property tax calculated with the standard tax rate of property tax on the tax base on housing ÷ the amount equivalent to the property tax calculated with the standard tax rate of property tax to the aggregate of housing].

D. Yet, “tax base on housing,” which is in the place of numerator of the instant equation in the Enforcement Decree, was previously expressed as “the amount exceeding the amount of tax base on housing” under the former Enforcement Decree of the Gross Real Estate Tax Act. It remained unspecified as to whether the instant equation in the amended Enforcement Decree referred to what was stipulated in the instant formula in the Enforcement Rule, or [(publicly reported price of housing subject to taxation – amount of taxation) × (fair market value ratio of comprehensive real estate tax × fair market value ratio of property tax) × property tax ratio].

E. The Supreme Court established a legal principle in Supreme Court Decision 2012Du2986 Decided Jun. 23, 2015, which stated that the instant equation in the Enforcement Decree refers to the latter, for the following reasons.

(1) A comprehensive real estate tax was introduced following the tax reform which took place on January 5, 2005. Its purpose is to increase tax fairness with regard to owning real estate property and to stabilize property prices by (i) first, imposing a property tax, which is a municipal tax, at low tax rate on those owning property subject to taxation; and then (ii) levying a comprehensive real estate tax, which is a form of national tax, at a high tax rate on those who own property beyond a standard tax amount of the aggregate of all domestic items subject to taxation. As both property tax and comprehensive real estate tax are levied on the same taxable capacity, that is, possession of the property subject to taxation, which might result in the problem of double taxation, the Gross Real Estate Tax Act, ever since its adoption on January 5, 2005 by Act No. 7328, prescribed that the tax amount imposed as property tax be exempted from the amount of comprehensive real estate tax.

(2) Such legislative measure maintained thereafter. The former Enforcement Decree of the Gross Real Estate Tax Act (amended by Presidential Decree No. 21293, Feb. 4, 2009), immediately before it was revised into the instant equation in the Enforcement Decree, prescribed under Articles 4-2, 5-

3(1) and (2) that the amount of exempted tax shall be calculated pursuant to the following equation: [the aggregate amount of property tax on housing × the amount equivalent to property tax calculated with standard tax rate of property tax on the amount exceeding the amount of tax base on housing ÷ the amount equivalent to property tax calculated with standard tax rate of property tax to the aggregate of housing].

(3) Articles 4-2, 5-3(1) and (2) of the former Enforcement Decree of the Gross Real Estate Tax Act were amended by Presidential Decree No. 21293 on February 4, 2009, under which "the amount exceeding the amount of tax base on housing," the numerator of the instant equation in the former Enforcement Decree, was revised into "tax base on housing," the numerator of the instant equation in the Enforcement Decree. Yet, the basic intention behind the amendment remains the same, which is to deduct the amount of property tax, levied repetitiously with comprehensive real estate tax, from the amount exceeding the amount of tax base; hence, the purpose of the amendment should not be construed as reducing or adjusting the scope of the amount of property tax subject to deduction.

F. The Plaintiff filed the instant lawsuit, alleging *per se* invalidation of the portion of the instant disposition exceeding the reasonable amount, which was calculated by using the formula for determining the amount of exempted tax in accordance with the legal principle established by the Supreme Court judgment, on the grounds of unlawfulness of the pertinent disposition and the existence of critical and apparent flaws therein.

2. As to the ground of appeal alleged by the Plaintiff

A. <u>To consider disposition of taxation *per se* invalid, mere existence of the grounds of illegality is insufficient; instead, (a) the flaws must be in critical breach of important elements of the law and objectively apparent; (b) determination on whether flaws are apparent and critical must be made in deliberate consideration of purpose, meaning and function of the laws and regulations that serve as the grounds for the said disposition of taxation, and decided by judicial consideration of the distinctive nature of the specific case at issue. Moreover, in a case where: (a) the tax authority rendered disposition of tax by applying relevant laws and regulations on certain legal or factual relations; (b) there is no room for dispute as to the interpretation of the applicable laws and regulations, as the legal principle clearly suggested the pertinent laws and regulations cannot be applied to those particular legal or factual relations; (c) nonetheless, the tax authority applied the said laws and regulations to make tax disposition, such flaws are deemed apparent and critical. However, where there exists room for dispute as to the interpretation of the application of laws and regulations in regard to the legal or factual relations at issue, the tax authority's tax disposition by misinterpreting the laws and regulations is simply a result of an erroneous acknowledgement of the facts regarding taxation requirements; hence, the flaws cannot be deemed apparent</u>

(Supreme Court Decisions 2006Da1633, Mar. 27, 2008; 2011Da103809, Dec. 26, 2013).

B. Having acknowledged the facts presented in the reasoning, the lower court dismissed the Plaintiff's allegation on the ground that (i) at the time of the tax disposition at issue, for the tax years of 2009 and/or 2014, (ii) the legal principle on the instant equation in the Enforcement Decree remained unspecified, which renders it impossible to deem that there exist apparent flaws in the pertinent disposition.

(1) The instant disposition was made by erroneously applying the instant equation of the Enforcement Decree. Therefore, there are flaws in the interpretation and application of the instant equation of the Enforcement Decree.

(2) However, it should be noted that: (i) at the time of the tax disposition assessed for the year 2009 and/or 2014, a number of administrative lawsuits had been filed with regard to the interpretation of the instant equation of the Enforcement Decree; (ii) also, several appellate trials deemed it legitimate to compute the amount of exempted tax by using what had been used in the instant formula in the Enforcement Rules; and (iii) there seems to have been reasonable grounds for such decision.

(3) Although the Supreme Court established the legal principle regarding the interpretation of the instant equation of the Enforcement Decree in Decision 2012Du2986 decided Jun. 23, 2015, it appears that there existed a window where one can dispute the interpretation of the instant equation prior to the pertinent decision by the Supreme Court. Therefore, it cannot be concluded that there existed apparent flaws, as long as there are insufficient grounds to assume that the instant tax disposition was made in spite of the absence of likelihood of dispute regarding the interpretation of the equation for computing the amount of exempted tax for the amount of tax assessed for the year 2009 and/or 2014.

C. Examining the record in light of the legal principle *supra*, the lower court did not err in its decision on this part by misapprehending the legal principle on the requirements for a tax disposition to be deemed invalid *per se*.

3. As to the Defendant's ground of appeal

A. The ground of appeal No. 1

Considering that the tax disposition on the tax assessment for 2015 was rendered on November 16, 2015, which came after Supreme Court Decision 2012Du2986 decided Jun. 23, 2015, the lower court decided that the tax disposition on the tax assessment for 2015 was deemed *per se* invalid, on the ground that: (i) at the time of the said tax disposition, there was no room for dispute over the interpretation of the legal principle on the instant equation of the enforcement Decree, which had been clearly specified through the said decision made by the Supreme Court; (ii) the circumstance which gives rise to the argument for the existence of apparent flaws in the portion of the instant disposition exceeding the reasonable amount.

Examining the record in light of the relevant legal principle, the lower court did not erroneously decide on this part by misapprehending the legal principle on the binding effect of a remanding judgment and *per se* invalidation of a tax disposition.

B. The ground of appeal No. 2

A tax refund constitutes unjust enrichment, which is either received or retained by the State without legal grounds, despite the nonexistence of tax liability at the outset or the lapse of such liability, whereas an additional refund is characterized as statutory interest on the unjust enrichment therefrom. The obligation to return unjust enrichment is an obligation with no fixed time limit, and thus a beneficiary is obliged to compensate any and all losses caused by delay in the performance of obligation following the day after receiving a claim for performance. Therefore, after the filing of a claim for the performance of obligation to refund tax money, a claim for additional payment on refund and a claim for losses caused by delay occur concurrently, one of which can be exercised by taxpayers at will (*see* Supreme Court Decision 2009Da11808, Sept. 10, 2009).

Having determined that the tax disposition exceeding the reasonable amount of tax in the tax year of 2015 was *per se* invalid, the lower court held that the Defendant was liable for the payment of loss caused by delay to compensate unjust enrichment, with regard to the aggregate of the tax assessment equivalent to the reasonable tax amount and additional tax refund, calculated by the following ratio: (i) from March 18, 2016, the day after the delivery of the written complaint of the instant case, to June 9, 2017, the date on which the lower judgment is declared, at an annual rate of 5%, as prescribed by the Civil Act; and (ii) from the next day of the declaration of the lower court decision to the day all compensation is delivered, at an annual rate of 15%, as prescribed by the Act on Special Cases Concerning Expedition, etc. of Legal Proceedings.

Such lower judgment is based on the legal principle *supra*, and the lower court did not err by misapprehending the legal principle on the scope of refund of unjust enrichment. Supreme Court Decision 2011Da95564 decided Mar. 21, 2013, which is cited in the grounds of appeal, is different from the instant case in terms of issues under consideration in the instant case, and therefore its invocation is inappropriate.

4. Conclusion

Therefore, all appeals are dismissed and the costs of appeals are assessed against each party. It is decided as per Disposition by the assent of all participating Justices on the bench, except for a dissent by Justices Kim Shin, Kwon Soon-il, Kim Jae-hyung, and Park Jung-hwa, followed by a concurrence with the Majority Opinion by Justices Lee Ki-taik and Cho Jae-youn and a concurrence with the Dissenting Opinion by Justices Kim Shin and Kwon Soon-il.

5. Dissenting Opinion by Justice Kim Shin, Justice Kwon Soon-il, Justice

Kim Jae-hyung, and Justice Park Jung-hwa

The Majority Opinion stated to the effect that a disposition of taxation exceeding a reasonable tax amount, rendered by the tax authority that erroneously interpreted and applied relevant statutes, and made during the period when there was room for dispute over interpretation and application of relevant statutes on taxpaying obligation, shall not be deemed *per se* invalid, because the flaws of the said disposition did not manifest apparently. However, such flaws in a tax disposition should be deemed as the grounds for invalidation of tax disposition. The reasons are as follows.

A. The Majority Opinion is in contravention of the principle of no taxation without representation, and is likely to undermine the essence of tax justice.

The principle of no taxation without representation states that (a) matters regarding taxpaying obligation, including requirements for taxation, shall be prescribed by law that is enacted by the National Assembly, a representative organ of the people; (b) the enforcement of such statutes shall be based on strict interpretation and application; and (c) extended interpretation or analogous application of law to attain administrative convenience shall be prohibited. The principle is intended to ensure the right to property by increasing the predictability and legal stability of tax payment obligations. The apparentness requirement of the principle of no taxation without representation intends to ensure that the statutes on the taxation requirements are stated in a clear and univocal manner, because if not, overly abstract and equivocal statutes may provoke arbitrary interpretation and enforcement of the tax authority (*see, e.g.,* Constitutional Court en banc Decision 2012Hun-Ba92, Jul. 25, 2013).

<u>Where there is room for dispute over the interpretation of the laws and regulations regarding a tax payment obligation, the imposition, report, and payment of tax on the basis of such laws and regulations constitute a breach of the principle of no taxation without representation, and are thus denied their validity and legitimacy.</u> Yet, the Majority Opinion applied the theory that there must be considerable and apparent flaws for administrative action to be deemed *per se* invalid to a case concerning a tax disposition, thereby concluding that even a taxation disposition rendered by the tax authority's misinterpretation of the statutes with limited apparentness does not constitute grounds for invalidation, as these flaws are not sufficiently apparent. Such conclusion of the Majority Opinion, however, may result in the breach of the principle of no taxation without representation by condoning arbitrary taxation by the tax authority, thereby undermining the essence of tax justice.

According to the record in the instant case: (a) even after Supreme Court Decision 2012Du2986 decided Jun. 23, 2015 was rendered, the tax authority did not *ex officio* revoke the dispositions imposing a comprehensive real estate tax in relevant cases having the same kind of flaws of applying the same erroneous taxation principle; (b) it was only after March 10, 2016, when the trial of re-appeal of Supreme Court Decision 2012Du2986 *supra* was concluded, that the tax authority began *ex officio* revocation of the dispositions imposing a comprehensive real estate tax in several relevant cases. These cases of actual enforcement by the tax authority serve as an example of (a) how taxation based on ambiguous statutes infringes upon the exercise of property rights; and (b) how an interpretation such as that of the Majority Opinion contributes to the condoning of arbitrary enforcement of the tax authority.

B. Disadvantages caused by statutory misinterpretation should not be transferred to taxpayers. Unlike general administrative legal relationships, the tax law relationship, which has a direct impact on the property rights and economic lives of ordinary citizens, has the characteristic of a claim-obligation relationship. As such, for a disposition of taxation: (a) protection of the third party, which trusts the existence of such taxation disposition, is not necessarily required; (b) and thus, even though the disposition is deemed *per se* invalid on the ground of its magnitude of illegality, the legal stability thereof is not undermined. Tax administration stability and demands for effective enforcement cannot serve as legitimate grounds for the failure to give a tax refund, which are erroneously imposed upon taxpayers and paid thereon. Where (a) there are critical flaws of misinterpretation of the laws and regulations regarding a tax obligation; (b) and, as a result, tax was levied and paid by a taxpayer, who did not have tax liability for that particular tax item; (c) failure to recognize the invalidity of such taxation disposition constitutes transfer of disadvantage, caused by misconstruction of relevant statutes, to taxpayers instead of the tax authority, which is unreasonable.

Furthermore, a State is an entity that not only establishes legal provisions regarding taxpaying obligations but also owns incomparable superiority over taxpayers in terms of statutory interpretation. In the event where there is room for dispute in terms of interpretation and application of ambiguous statutes, it is the State that ought to bear the disadvantages arising therefrom, as such laws were created by the State itself. It is unreasonable to transfer disadvantages to or hold accountable individuals who are not responsible for the creation and application of the pertinent statutes. The Majority Opinion, which states that (a) inasmuch as there exists room for dispute with regard to statutory interpretation as the legal principle thereof remains unspecified, (b) the flaws with such taxation principle may not be deemed *per se* invalid, as they do not satisfy the apparentness requirement, is a theory that potentially enables the State to transfer its liability, which is in contravention of the Constitution, not to mention universal moral concepts.

C. A State shall not limit remedial measures for taxpayers, and by doing so breach its purpose of existence, which is to safeguard the rights and property of its citizens.

In a case where: (a) the tax authority made taxation disposition based on the interpretation of relevant laws and regulations in regard to certain legal or factual relations; (b) but it was later confirmed that the pertinent legal principle

<u>was erroneous, and thus, that the said taxation disposition lacked legitimacy; (c) the State is obliged to correct such disadvantage by providing adequate remedy. If the State fails to provide such remedy or restricts remedial measures, refuses to give a tax refund, and enjoys the benefits accrued therefrom, the State acts in violation of the purpose of its existence—protecting its people's rights and property</u>.

The tax law relationship is not easily comprehended, as the statutory content thereof is extremely complicated and subject to frequent revision, which makes it arduous even for legal experts to fully grasp its meaning. In the case where: (a) the tax authority made unlawful taxation disposition; (b) taxpayers may not acknowledge in a timely manner that the statutory interpretation on which the said disposition was based is erroneous; and thus, (c) fail to file for either administrative relief or a lawsuit to revoke such disposition, and miss the deadline to file an objection. In that case, (a) where there are no administrative mechanisms to receive tax refunds other than undertaking litigation to claim for *per se* invalidation of a taxation disposition, (b) it is completely unreasonable, in terms of taxpayer remediation, for a State to coerce taxpayers into tolerating disadvantages instead of setting the record straight by itself, on the sole ground of the taxpayers having missed the deadline to file an administrative lawsuit for tax disposition based on misinterpretation rendered by the tax authority. This is especially so when compared to the fact that the tax authority can always impose tax within the limitation period, along with additional tax in form of administrative sanction.

D. Where a Supreme Court decision has conclusively confirmed that the principle of taxation at issue was erroneously applied, such flaw must be deemed ground for invalidation.

Judicial precedents state that: (a) in order for a taxation disposition to be deemed *per se* invalid, the flaws thereof must be critical, in breach of an important part of the statutes at issue, and objectively apparent; (b) meanwhile, where a taxation disposition is not based on reasonable legal grounds and lacks rationality, the flaws thereof are deemed critical and apparent, invalidating the pertinent disposition (*see, e.g.,* Supreme Court Decision 2014Du47099, Nov. 14, 2017). A case in which a Supreme Court decision reveals that a certain tax principle arose out of misinterpretation and erroneous application of relevant statutes constitutes a case where a taxation disposition with such tax principle applied is deemed to be lacking reasonable legal grounds and rationality from the outset.

Whether a certain taxation disposition lacks reasonable legal grounds and rationality is not determined depending on (a) whether a Supreme Court decision was rendered; or (b) temporal order with regard to the pronouncement of court decisions, either pre-decision or post-decision. In other words, the fact that there are no objectively reasonable legal grounds and rationality in the pertinent principle of taxation is simply affirmed upon the declaration of a

Supreme Court decision. Hence, the circumstance that there exist no objectively reasonable legal grounds and rationality should be applied equally, both before and after the declaration of a relevant Supreme Court decision. No logical or inevitable reasons exist with regard to the argument that, as alleged in the Majority Opinion, flaws regarding the principle of taxation, affirmed by a Supreme Court decision, are deemed to fall short of the apparentness requirement prior to a Supreme Court decision, and satisfy the requirement only after the declaration of the Supreme Court's decision.

In conclusion: (a) even when considering that the flaws in taxation disposition must be critical and apparent in order to be acknowledged as invalid; (b) where the Supreme Court rendered a decision confirming that the legal principle applied to a taxation disposition was derived from misinterpretation and erroneous application of the laws on taxpaying obligation; (c) the said flaws cannot be deemed grounds for invalidation on the ground of lack of the apparentness requirement before the said decision was rendered.

E. As seen above, in a case where tax, set higher than the legitimate amount, was imposed and paid as a result of misinterpretation and application of the laws regarding taxpaying obligation, the flaws in the said taxation disposition should be deemed grounds for invalidation.

Yet, the lower court rejected the remedy for the Plaintiff, determining that: (a) among the taxation disposition in the instant case, at the time of the disposition which pertains to the tax for the tax years of 2009 and/or 2014; (b) the legal principle on the instant equation in the Enforcement Decree remained unspecified, which makes it difficult to deem the flaws apparent; (c) therefore, the relevant portion of the said taxation disposition *supra* cannot be deemed *per se* invalid. Such lower judgment is erroneous in that it misapprehended the legal principle regarding *per se* invalidation of a taxation disposition, and the Plaintiff's argument in this point is with merit. Therefore, the part of the lower judgment against the Plaintiff must be reversed and the case must be remanded to the lower court for further proceedings consistent with this Opinion.

For the foregoing reasons, we dissent with the Majority Opinion.

6. Opinion concurrent with the Majority Opinion by Justice Lee Ki-taik and Justice Jo Jae-youn

A. Recognition of flaws existing in taxation disposition as the ground for invalidation should be limited to exceptional cases. Remedy Having a remedial procedure under tax law, which, in principle, reflects the characteristic of the principle of no taxation without representation, that provides a remedy for taxpayers, is preferable on the following grounds.

(1) Unlike obligations arising in general juristic relationships, which recognize private autonomy, the establishment and exercise of tax obligations must adhere to the law, and stakeholders must not arbitrarily make changes to the context thereof contrary to statutory provisions. Tax is central to a State's financial system, which is a foundation for the existence of the State: its role as

promoting public interest and its public nature are ensured by entrusting the tax authority, which exercises public authority, with considerable power to ensure payment and collection of tax, including the right to inquire and investigate, the right to exercise preferential right, and the right to execute by its own force. Statutes regulating the tax law relationship, which is a public burden shared by all citizens and has its own function and purpose, are extremely technical and complicated, requiring expertise to accurately understand and enforce them. Furthermore, the tax law relationship is differentiated in that it is established as a group and in a periodic and repetitive manner. As such, the tax law relationship is different from a claim-obligation relationship in a number of elements. Tax administration needs to (a) ensure stable tax revenue through prompt and efficient imposition and collection of tax by means of bulk and repetitive disposition of taxation; and (b) promote tax fairness in light of substantial transaction. Therefore, tax administration should take into account remedial measures for taxpayers by comprehensively considering the entire circumstances instead of only highlighting individual features.

(2) A tax obligation is automatically established when the statutory requirements are satisfied: however, in order to claim for the performance of tax obligation, one must conduct a procedure in which the substance of tax obligation, objectively and abstractly defined, is confirmed specifically. This is usually done through taxation disposition. As such, a tax law relationship is forged between taxpayers and the tax authority on an individual and specific basis through a procedure that determines the amount of tax, including taxation disposition accompanied by tax payment notice. It is reasonable that a remedy upholding taxpayers' rights must ensure the filing of complaint for such taxation disposition. Yet, as for disputes over legal relationship under public law, the Administrative Litigation Act is in place to regulate the litigation procedure, as its purpose, intent, and function differ from that of civil lawsuits, whose subject is concerned with disputes over an organic relationship under private law between equal parties. Therefore, tax litigation, which: (a) seeks to revoke or alter unlawful disposition rendered by the tax authority; or (b) confirms the existence of the legal effect thereof, or the existence of such disposition; (c) is for the purpose of offering redress to individuals whose rights or interests have been infringed, and reasonable settlement of disputes regarding the rights based on public law or statutory application, is also governed by the Administrative Litigation Act. This process is intended to ensure prompt and efficient remedy for the rights infringed, and enable reasonable tax administration.

Legislators have introduced procedures for tax law administration along with litigation procedures contingent on the application of the Administrative Litigation Act, both of whose nature are different from the one governing a claim-obligation relationship under private law. Recognizing the independent nature of a tax law relationship, such separate procedures are intended to strike a balance between (i) the exercise of the right to taxation for the purpose of funding various expenditures carried out by a State, and (ii) the restrictions imposed therefrom on an individual's property and freedom. Legislative discretion is acknowledged with regard to the procedure, method, and limit determined by law. Therefore, the policy judgments of the legislature, barring special circumstances, must be respected.

(3) The Framework Act on National Taxes regulating the issues pertaining to the right, obligation, and redress of rights violations categorizes tax litigation into (i) complaints procedure against administrative agency and (ii) administrative lawsuits. Article 56(2) of the Framework Act on National Taxes stipulates "no administrative litigation against an illegal disposition prescribed in the Framework Act on National Taxes or the tax law shall be filed without a request for examination or adjudgment and a decision on such request," upholding the principle of examination before administrative trial with regard to administrative litigation. Article 56(3) of the Framework Act on National Taxes states that "any administrative litigation shall be filed within 90 days from the date when a decision on a request for examination or adjudgment is notified."

The fundamental purpose of the Framework Act on National Taxes that requires a compulsory administrative trial for tax disputes in connection with period for filing lawsuit, unlike other legal relationships, is: (a) to ensure, as a final resort, the right to redress through judicial process, while requiring administrative trials by the administrative institution, as a process before a trial; (b) thereby granting the opportunity for the administrative authority to examine the legitimacy of the taxation disposition at issue, and reconsider and revise when needed; and (c) provide convenience to taxpayers by reducing the cost of litigation and saving time (*see, e.g.*, Supreme Court Decision 88Nu7996, Nov. 11, 1989).

Such remedial procedures provided under tax law do have some restrictions with regard to the time limit for filing lawsuits, procedures, and methods when compared to other remedial procedures. However, these are the result of reflecting the characteristics of tax administration as examined earlier, and thus cannot be deemed apparently unreasonable or unfair. Instead, it is more desirable to settle tax disputes through a single-stream process, that is, a remedial procedure under tax law, which would strengthen legal stability. Allowing separate means to file a complaint in which the restrictions seen *supra* are not imposed on taxation disposition, which is a form of administrative disposition, might seriously compromise and undermine tax administration, which provides the State's fiscal foundation by serving the role of promoting public interest with its public nature.

(4) As seen above, under current tax law, taxpayers can receive redress, in principle, by filing an appeal against administrative actors for revocation of a tax disposition, which would immediately void the effect of unlawful

disposition of taxation. On the other hand, when a certain disposition of taxation is deemed *per se* invalid, the amount of tax paid by or collected from taxpayers following the said taxation disposition (hereinafter "wrongfully collected tax") constitutes unjust enrichment gained by the State, which are not legally due. Taxpayers may directly file a civil lawsuit to seek a refund of unjust enrichment, that is, a wrongfully collected tax, on exceptional grounds notwithstanding the existence of taxation disposition (*see, e.g.*, Supreme Court Decisions 91Da32053, Mar. 31, 1992; 2013Da212639, Aug. 27, 2015), and in such case, taxpayers do not have to resort to remedial procedures under the tax law.

In sum, whether to view the flaws in a taxation disposition as (a) grounds for revocation, which is subject to certain restrictions, such as the compulsory prepositive appeal principle or period for filing a suit; or (b) grounds for invalidation, which allows for immediate redress by a civil lawsuit without being subject to any restriction (which are imposed in the case of grounds for revocation), depends on how to determine the subject and scope to be exempted from the remedial procedure under the tax law, interposed by legislators, who took into account the characteristics of the tax law relationship.

Reasonable interpretation that takes into account the remedial procedure under the tax law, introduced by considering the characteristics of the tax law relationship, deems that, in principle, the flaws in taxation disposition are grounds for revocation; provided that the flaws are critical and apparent to the extent that maintaining the legal stability of administration has become the absolute imperative, which constitutes an exceptional case under which such flaws are deemed grounds for invalidation. In line with the interpretation *supra*, many judicial precedents have upheld the legal principle that "to consider disposition of taxation *per se* invalid, the existence of the ground of illegality is insufficient; instead, the flaws must be in critical breach of important elements of the law and objectively apparent." The Majority Opinion viewing that: (a) it is not until the tax obligation is specifically confirmed through a notice of tax payment that taxpayers become able to recognize realistically the finalized amount of tax; and (b) taking into account such situation, legislators made a law stipulating that the flaws in a specific taxation disposition, which is an embodiment of a tax obligation, shall be contested, in principle, in the court of appeal. The view presented by the Majority Opinion also corresponds to the current tax law, which has interposed the remedial procedure under tax law separate from the civil litigation procedure.

(5) A case where the flaws existing in taxation disposition are recognized as grounds for invalidation on an exceptional basis is open to criticism that it would restrict the means of redress by civil litigation, thereby falling short of the protection of taxpayers' rights. However, even if the stance akin to that of the Majority Opinion, which restrictively construes the ground for invalidation, were maintained, there would still exist supplementary measures that could offer protection for taxpayers when, in individual cases, imposition of a tax

obligation is considered extremely unjustified. There are judicial precedents: (a) stating that reasonable examination of distinctiveness of individual cases must be reasonably examined in determining *per se* invalidity of taxation disposition (*see, e.g.,* Supreme Court Decision 2000Da24986, Jul. 10, 2001); and (b) deeming a taxation disposition lacking in objectively reasonable legal grounds and rationality as invalid (*see, e.g.,* Supreme Court Decision 2014Du47099, Nov. 14, 2017). Furthermore, the methods of redress are available for taxpayers (i.e. the right to request for correction) under tax law. The Framework Act on National Taxes introduced the procedure of request for correction, which ensures correction of the tax base and amount of taxes. Furthermore, the period for request of correction was extended up to 5 years, equivalent to the period of prescription for the (i) exclusion period of imposition, and (ii) right to claim a refund of what has been obtained in the form of unjust enrichment. As such, maintaining the same stance with the Majority Opinion does not necessarily equate to avoiding the offer of protection or having inadequate protection for taxpayers.

B. The argument of the Dissenting Opinion may be boiled down as follows: (a) where the tax authority made a tax disposition based on an erroneous taxation principle by misapprehending taxing statutes; or (b) where a Supreme Court decision confirmed that the relevant taxation principle contained errors; (c) the said taxation disposition is deemed invalid. While agreeing to the fact that the scope of protection needs to expand for the sake of taxpayer protection, which is partly worth listening to, we find it difficult to assent to the logic or conclusion of the said argument.

(1) In a tax litigation where: (a) taxpayers claim that taxation disposition is unlawful because the legal principle applied to the said disposition is based on erroneous statutory interpretation; (b) deeming such type of flaws as grounds for invalidation is hardly different from viewing most of the flaws related to tax administration practices as grounds for invalidation. If the grounds for invalidation of the flaws in taxation disposition are to be expanded as seen above, (a) the appeals procedure and the procedure for administrative litigation by taxpayers against the administrative agencies would likely be reduced to a perfunctory mechanism; and (b) disputes over a tax law relationship are also likely to transform into that of the civil law system, eliminating the need for administrative trials and administrative litigation. This would significantly nullify some of the provisions under the current tax law pertaining to administrative trials, and the procedure for administrative litigation, including the principle of prepositive administrative appeal, period for filing a suit, and redress mechanism by allowing requests for correction, which are put in place taking into account the distinctive features of a tax law relationship. Furthermore, if taxpayers will become able to invalidate the effect of legal relations forged through taxation disposition at any time within the prescription period for filing a claim for a refund against unjust enrichment, not only would

overall tax administration be jeopardized but also its aftermath on the tax administration practices, which have been formed with appellate procedures at the center, would be immeasurably high.

(2) In addition, we dissent with the portion of the Dissenting Opinion, which argues that where a Supreme Court decision finds an error in a taxation principle, the flaws in all tax dispositions to which the same principle applied shall be deemed grounds for invalidation.

The Dissenting Opinion seems to understand that whether flaws in taxation disposition in a certain case constitute grounds for invalidation should be determined by a Supreme Court decision on relevant cases dealing with the same issue. However, whether the flaws existing in taxation disposition are grounds for invalidation or the grounds for revocation is: (a) a matter to be determined from the perspective of substantive law based on consideration of the individual case at issue; (b) rather than a matter to be determined by a Supreme Court decision in a relevant case distinguishable from the case at issue.

Moreover, it is difficult to readily assent to the argument of the Dissenting Opinion, as there is insufficient body of research and discussion accumulated with regard to the specific requirements, the extent to which it would apply, and the potential ramifications therefrom. The adoption of the argument of the Dissenting Opinion must be preceded by a thorough examination of the impact and ramifications on tax administration. The Dissenting Opinion leaves certain issues unclear, such as: (a) whether a flaw which was not the ground for invalidation under substantive law suddenly becomes the ground for invalidation by a Supreme Court decision, which is a subsequent and outside event; or (b) whether a Supreme Court decision on a relevant case can directly impact the conclusion of judgment of the case at issue.

Even if the flaws in taxation disposition were deemed grounds for invalidation as alleged in the Dissenting Opinion, taxpayers, intent on getting a refund of the amount of tax either overpaid or paid without legal basis, must first have the grounds for invalidation recognized before completion of prescription of the right to claim a refund against unjust enrichment. However, according to the Dissenting Opinion, determination on whether or not to grant the right to claim a refund against unjust enrichment is decided, regardless of the conduct or will of the taxpayer seeking a refund against unjust enrichment in the case at issue, on the basis of the pronouncement of a Supreme Court decision in a relevant case brought by other taxpayers, which is unreasonable and unfair. These are some of the reasons why it is difficult to support the argument of the Dissenting Opinion.

Furthermore, such argument may raise fairness concerns between (a) a taxpayer, who contested a tax disposition by actively pursuing the remedial procedure under tax law, but finally lost in administrative litigation, and thus subject to its *res judicata* effect; and (b) a taxpayer who did not seek remedial procedures for taxation disposition, but has become eligible for remedy by a

Supreme Court decision in a relevant case dealing with the same issue.

(3) The apparentness principle arising from the principle of no taxation without representation states that requirements for taxation shall be clearly defined to the extent that it is allowed under legislative description. However, a clear distinction must be made between (a) a case where the statutes regarding taxation requirements are overly abstract and unclear; and (b) a case where (i) the provisions of the statutes on taxation requirements use unspecified concepts due to the limitations in legislative description; (ii) which gives rise to the need for specification of statutory meaning and the substance thereof through the reasonable statutory interpretation in light of the intent and purpose of the pertinent statutes. This is especially so in the area of tax law, (a) which not only is grounded upon various legal relations but also requires a high level of sophistication and technicality in terms of its substance; and (b) where the issue of whether certain provisions of the statutes regarding taxation requirements or tax reductions are applicable to the legal or factual relations at issue remains unspecified from the legal principle perspective. In light of the initial intent of the apparentness principle or the characteristic of the tax law relation, it is unreasonable to deem a taxation disposition always invalid, for being in breach of the apparentness principle, where (a) the tax authority, having adopted a certain perspective, has been interpreting and applying relevant laws; (b) and there exist considerably reasonable grounds regarding such practice of the tax authority; (c) but nonetheless disregard such circumstances and deem the taxation disposition based on the initial interpretation as always invalid so long as the Supreme Court's decision, taking the opposite stance, overturns the interpretation of the tax authority.

Furthermore, legislators have introduced a preemptive mechanism for relief, including advance tax notice and review on legality before taxation, along with *ex-post* relief mechanism. In principle, the flaws in taxation disposition may be dealt with first in administrative trials and then in the appeals court. Under the current system, where most taxes are paid by report, taxpayers may exercise the right to request correction of a tax disposition, which is equivalent in force to the tax authority's right to impose tax, thereby providing taxpayers with the means to file a complaint against the disposition rejecting a request for correction. As noted above, tax law offers various protective measures to taxpayers by taking into account the distinctive feature of the tax law relation, a type of legal relations under public law, considering the distinction between public law and private law. Tax administration practices have also been established accordingly. Noting that the tax law already provides various protective measures and litigation procedures, it is dubious that whether it is justifiable to invert the entire tax law and provoke chaos in tax administration by broadly allowing taxpayers, who have failed to take advantage of the remedial measures under public law, to resort to remedial measures through civil lawsuits, which was previously allowed only on exceptional occasions, under the abstract banner of the principle of no taxation without representation or tax justice.

We express our concurrence with the Majority Opinion as stated above.

7. Opinion concurrent with the Dissenting Opinion by Justice Kim Shin and Justice Kwon Soon-il

A. The Dissenting Opinion states to the effect that the scope of taxpayer protection by means of civil lawsuits must be expanded in number, which are already permitted by several judicial precedents.

Judicial precedents have ruled that: (a) in a case of a taxation disposition that is deemed *per se* invalid; (b) the payment or collection of taxes that was not legally due constitutes unjust enrichment by the State; and (c) taxpayers can directly file a claim for the refund thereof through a civil lawsuit. Such taxpayer relief measures by means of a civil lawsuit is a separate form of relief, which are distinguished from a complaint procedure against the administrative authority or administrative litigation under tax law in terms of purpose, procedure, methods, and limitation thereof. There are no laws regulating the expansion of the scope of taxpayer relief by means of a civil lawsuit. Judicial precedents have mainly presented a standard of determining a taxation disposition *per se* invalid, which requires the flaws of such taxation disposition to be sufficiently apparent and in breach of critical elements of the pertinent provision.

The gravamen of the Dissenting Opinion is to expand the scope of taxpayer relief by means of a civil lawsuit, which the judicial precedents have already approved of, instead of making a qualitative change, which is, namely, to introduce new ways of taxpayer relief that were previously prohibited. The interpretation adopted by the Dissenting Opinion does not necessarily undermine the integrity of the remedial procedure under tax law, laid out on the basis of the distinctiveness and technicality of tax administration, nor does it debilitate the essence of the tax law itself.

B. Where the remedial procedure under tax law is insufficient for taxpayer relief, the court is obliged to protect taxpayers by rendering a reasonable statutory interpretation.

The imposition or collection of tax in a tax law relationship is subject to administrative action, which inevitably involves the characteristic of legal relations distinguishable from that of private law. Moreover, one must make use of litigation procedures put in place under tax law taking into account such aspects of the tax law relationship. Assuming the litigation procedure under tax law is sufficient to protect and provide redress for the rights and interests of taxpayers, there would be no need for additional relief measures. However, taxpayers seeking redress by means of a remedial procedure under tax law shoulders the burden of (a) understanding complicated and convoluted laws on their own in a short period of time; (b) filing a complaint against the administrative authority; and (c) filing an administrative lawsuit within 90 days after the determination of the administrative authority. If such procedure does not serve its purpose of taxpayer protection, the court must expand the scope of relief to the possible extent.

The need for taxpayer protection arises when it comes to a tax disposition applying a legal principle which leaves room for dispute in terms of its interpretation. The State does not have an authority to collect taxes that exceed reasonable amount prescribed by law. It is the State that created a tax law with possibility of unclear interpretation; likewise, it is the State that rendered an incorrect tax disposition by misinterpreting and erroneously applying the tax law in question. To all appearances, the responsibility for such flaws lies in the State, not the taxpayers. It is extremely unreasonable to transfer the responsibility to taxpayers on the sole ground that taxpayers, lacking in legal knowledge, failed to file a lawsuit within a short deadline for filing litigation, by which the State is exempted from the responsibility of return the tax collected to taxpayers.

C. The Majority Opinion’s presentation of the concept and the method of application of the apparentness of flaws is unreasonable.

Understanding the meaning of the apparentness of flaws, presented by the Majority Opinion is difficult. As noted earlier, judicial precedents ensure that statutory intent, meaning, and function are purposefully examined, along with judicial examination of the distinctiveness of an individual case, in determining (i) whether certain flaws constitute grounds for invalidation; and (ii) the degree of apparentness of flaws. Such judicial precedents indicate that the determination of apparentness does not always result in a simple and clear answer, nor does it lead to a single conclusion.

Meanwhile, the Majority Opinion suggests a rather monolithic standard for the application of apparentness of flaws, that is, where a legal principle remains unspecified, leaving room for dispute with regard to its interpretation, the standard of the apparentness requirement is deemed not satisfied. According to such standard, the more complicated and convoluted a certain provision is, leaving room for a number of possible interpretations, the more difficult it is to satisfy the apparentness requirement. In other words, a tax disposition with statutes having more than one interpretation is less prone to invalidated. In a case where: (a) statutes imposing a tax obligation are unclearly written, rendering it difficult for taxpayers to identify whether or not they have a tax obligation, and the scope of such obligation; (b) even though setting aside the issue of whether the said statutes can be deemed legitimate as tax law, taxpayers with insufficient knowledge of taxation, imposed with a tax disposition grounded upon such unclearly written statutes, may become confused as to whether or not they are eligible to raise an appeal against the said tax disposition.

If a high level of statutory ambiguity lowers the likelihood of a tax disposition to be invalidated, there is a chance that both taxpayers and the tax authority will become neglectful, where: (a) taxpayers seeking first to raise an appeal against a tax disposition before the lapse of the fixed period for making an appeal; and (b) the tax authority imposing tax without first carefully examining the possibility of taxation. It is needless to say that such outcome is undesirable, not to mention that taxpayers who do not raise an appeal and comply with tax disposition become less likely to receive redress compared to taxpayers who actively make an appeal.

Taking the above into account, determining the invalidity of taxation disposition, in connection with the unclear concept of apparentness of flaws and the method of its application as presented by the Majority Opinion, is unreasonable. As a result of applying such monolithic standards to the instant case , the Majority Opinion determined: (a) on the basis of the time when the Supreme Court renders a decision in a relevant case, which confirms the pertinent taxation principle has flaws of statutory misinterpretation; (b) the taxation disposition made prior to the said Supreme Court decision does not have apparent flaws, and the taxation disposition made after the said Supreme Court decision has apparent flaws. Such conclusion of the Majority Opinion seems to be a one-size-fits-all judgment, which determines invalidity of taxation disposition based on when and how a Supreme Court decision to a relevant case is rendered instead of comprehensively taking into account the outcomes of purposeful examination of pertinent statutes and judicial determination of the distinctiveness of an individual case. Whether certain taxation disposition constitutes a *per se* invalid disposition must be determined on the sole ground of the degree of apparentness of the flaws in the disposition at issue.

We express our concurrence with the Dissenting Opinion as stated above.

Chief Justice	Kim Myeongsu (Presiding Justice)
Justices	Ko Young-han
	Kim Chang-suk
	Kim Shin (Justice in charge)
	Kim So-young
	Jo Hee-de
	Kwon Soon-il
	Park Sang-ok
	Lee Ki-taik
	Kim Jae-hyung
	Cho Jae-youn
	Park Jung-hwa
	Min You-sook

Supreme Court en banc Decision 2018Da22008 Decided July 19, 2018 【Indemnification】

【Main Issues and Holdings】

In a case where the ten-year extinctive prescription of a claim based on a final and conclusive judgment is nearing expiration, whether there exists a benefit of re-instigating a suit for the interruption of prescription (affirmative), and whether in such case the court in which the subsequent suit was filed may re-examine whether all necessary requirements have been satisfied to assert such established right (negative)

【Summary of Decision】

[Majority Opinion] Inasmuch as a final and conclusive judgment in favor of one party has *res judicata* effect, where said party instigates a suit against the other party for a claim identical in the previous suit in which a final and conclusive judgment was rendered, the subsequent suit is unlawful as there is no benefit in the protection of rights. *Provided*, however, if the ten-year period of extinctive prescription is nearing its lapse time for a claim based on a final and conclusive judgment, there exists benefit of a lawsuit.

Furthermore, given that the judgment of a subsequent suit cannot be incompatible with the final and conclusive judgment rendered in favor of one party in a prior suit, the competent court hearing the subsequent suit cannot re-examine whether all necessary requirements have been satisfied to assert such established right.

In cases where the ten-year extinctive prescription of a claim established by a previous final and conclusive judgment is nearing the lapse time, the Supreme Court has maintained the legal doctrine that there exists benefit in the re-instigation of a suit for interrupting prescription. This legal doctrine holds true even today. In regards to other causes interrupting prescription (such as seizure, provisional seizure or approval), the number of times in which such causes can be effectuated is not limited to one instance; thus, no rationale exists to deem that only a judicial claim ought to be limited to one instance. Also, insomuch as an obligation established by a final and conclusive judgment can be entirely or partly set-off through insolvency or rehabilitation proceedings, permitting an obligee to re-instigate a suit for the interruption of prescription is reasonable.

[Dissenting Opinion by Justice Kim Chang-suk, Justice Kim Shin, Justice Kwon Soon-il, and Justice Park Sang-ok] The Majority's position is premised on the fact that a claim established by a judgment ought to be kept from being extinguished due to prescription so long as the claim is not fully satisfied by means such as repayment. We dissent from this view as it contravenes the fundamental principle of the Civil Act that provides for the extinguishment of a claim and the extinctive prescription system and the doctrine of civil proceedings that acknowledges the *res judicata* effect of a final and conclusive judgment. Therefore, the Supreme Court precedent to which the Majority Opinion follows should be overruled.

(1) A claim extinguishes upon completion of the extinctive prescription period. As seen earlier, a claim is premised on a temporary nature that is based on "extinguishment" and the Civil Act also acknowledges the extinguishment of an unsatisfied claim. Therefore, in construing and applying the extinctive prescription system, this does not justify the need to prevent unsatisfied claims from extinguishing and to extend the maturity period until a claim is satisfied to prevent such extinguishment. Rather, the Majority Opinion to the effect that extinctive prescription ought to be prevented is inconsistent with the inherent nature of a claim and the provisions under the Civil Act.

(2) In view of the purport of the Civil Act that provides for extinctive prescription and interruption of prescription, this does not imply that a claim does not permanently extinguish via the repeated application of Article 165(1) without restriction that sets the prescription period of a claim established by a judgment at ten years and Article 168(1) that provides "demand" as the cause interrupting prescription. However, according to the Majority Opinion, even a claim that falls under a short-term extinctive prescription of one year can become a permanent claim if a judgment is rendered through instigation of a suit every ten years. This conclusion cannot be said to accord with the purpose of the extinctive prescription system under the Civil Act.

(3) A plaintiff, as an enforcement title holder upon having been rendered an enforceable judgment, does not possess a legal benefit of instigating an identical suit under the Civil Procedure Act. Pursuant to Article 170 of the Civil Act, so long as a legitimate judicial claim is deemed a cause interrupting prescription premised on the principle of the Civil Procedure Act, deeming that a judicial claim cannot be sought again when a final and conclusive judgment in favor of one party has already been rendered is logically consistent.

(4) Among the causes interrupting prescription, "approval" is indicative of an obligor's intent to perform his/her obligation and should not be restricted. Conversely, should there be a valid seizure, provisional seizure or provisional disposition, then seeking effectuation of the same cause would be unlawful and thus impermissible. Also, Article 174 of the Civil Act strictly provides that the effectiveness of the interruption of prescription shall not be repeatedly acknowledged regardless of the number of times peremptory notice was given. In that sense, we point out that proscribing the re-instigation of a suit does not mean that "demand by judicial proceedings (judicial claim)" is treated differently with other causes interrupting prescription as defined under Article 168 of the Civil Act.

(5) If the existence of a permanent claim were to be acknowledged by permitting a suit to be re-instigated for interrupting prescription, this would incite rampant debt collection practices and thus lead to social problems, i.e., imposing heavier debt burden on the economically marginalized who lack debt repayment capacity.

【Reference Provisions】 [1] Articles 162(1), 163, 164, 165(1), 168, 170(1), 174, 178, 184(2), and 766 of the Civil Act; Articles 216, 218, and 248 of the Civil Procedure Act

Article 162 of the Civil Act (Extinctive Prescription of Claims or Property Right)

(1) The extinctive prescription of a claim shall become complete if not exercised for a period of ten years.

Article 163 of the Civil Act (Short Extinctive Prescription for Three Years)

The extinctive prescription of claims defined in the following subparagraphs shall become complete if not exercised for a period of three years: *<Amended by Act No. 5454, Dec. 13, 1997>*

1. Interest, support fees, salaries, rent, and other claims purporting for the delivery of money or other things within a time limit of one year;
2. Claims of medical practitioners, midwives, nurses, and pharmacists for medical treatment, professional services, and dispensation of medicines;
3. Claims of contractors, engineers, and persons engaging in planning or supervising works for execution of their works;
4. Claims against attorneys-at-law, patent agents, notaries public, certified public accountants, and certified judicial scriveners for the return of documents kept in connection with their services;
5. Claims of attorneys-at-law, patent agents, notaries public, certified public accountants, and certified judicial scriveners for their services;
6. Items received in exchange for products and merchandise sold by producers and merchants;
7. Claims of artisans and manufacturers for their works.

Article 164 of the Civil Act (Short Extinctive Prescription for One Year)

The extinctive prescription of claims mentioned below shall become complete if not exercised for a period of one year:

1. The right to claim fees of hotels, restaurants, assembly rooms for hire, places of lodging and entertainment, refreshment, hire of rooms, admission fees, and the price of articles of consumption, as well as for substituted donation of another person;
2. Claims of rent for the hire of clothing, bedding, funeral necessaries, and other movables;
3. Claims of wages of manual workers and public performers and the price of articles supplied to them;

4. Claims of school proprietors, keepers of boarding schools, and teachers for the education, clothing, food, and lodging of pupils, and apprentices.

Article 165 of the Civil Act (Extinctive Prescription of Claims Established by Judgment, etc.)

(1) The period of extinctive prescription of claims established by a judgment shall be ten years, even where the period for the original claim is shorter under the Act.

Article 168 of the Civil Act (Causes Interrupting Extinctive Prescription)

Extinctive prescription shall be interrupted in any of the following cases:

1. Demand;
2. Attachment, provisional attachment or provisional disposition;
3. Acknowledgment.

Article 170 of the Civil Act (Demand by Judicial Proceedings and Interruption of Prescription)

(1) A demand by way of judicial proceedings shall have not effect of interrupting prescription, if the judicial action is dismissed, rejected or withdrawn.

Article 174 of the Civil Act (Peremptory Notice and Interruption of Prescription)

A peremptory notice shall have no effect of interrupting prescription unless a demand by judicial proceedings, intervention in bankruptcy proceedings, a summons for compromise or a voluntary appearance for the same purpose, an attachment, a provisional attachment or a provisional disposition is taken within six months.

Article 178 of the Civil Act (Running of Prescription after Interruption)

(1) Where a prescription is interrupted, the period of prescription passed until the interruption shall not be computed, and the prescription which was interrupted begins to run anew from the time when the cause of such interruption has ceased to exist.

(2) Prescription which was interrupted by a demand by judicial proceedings begins to run anew from the time when the judgment thereon becomes finally binding in accordance with the provisions of the preceding paragraph.

Article 184 of the Civil Act (Waiving of Benefit of Prescription, etc.)

(2) Although extinctive prescription shall, by a juristic act, not be excluded, extended or aggravated, it may be shortened or lessened.

Article 766 of the Civil Act (Prescription in respect of Right to Claim for Damages)

(1) The right to claim for damages resulting from an unlawful act shall lapse by prescription if not exercised within three years commencing from the date on which the injured party or his/her legal representative becomes aware of such damage and of the identity of the person who caused it.

(2) The provisions of paragraph (1) shall also apply if tend years have

elapsed from the time when the unlawful act was committed.

Article 216 of the Civil Procedure Act (Objective Extent of *Res Judicata*)

(1) A final and conclusive judgment shall have the effect of *res judicata* insofar as the matters contained in the text thereof are concerned.

(2) An adjudication on whether or not a claim alleging a setoff is constituted shall have the effect of *res judicata* only in respect of the amount pleaded to offset.

Article 218 of the Civil Procedure Act (Subjective Extent of *Res Judicata*)

(1) A final and conclusive judgment shall be binding on the parties, successors subsequent to a closure of pleadings (successors subsequent to a pronouncement of judgment, in cases of a judgment without holding any pleadings), or persons possessing the object of claims on their behalf.

(2) In cases falling under paragraph (1), when a party has failed to state the fact of succession not later than a closure of pleadings (when a judgment is pronounced, in cases of a judgment without holding any pleadings), it shall be presumed that such succession has been made after a closure of pleadings (after a pronouncement of judgment, in cases of a judgment rendered without holding any pleadings)

(3) A final and conclusive judgment rendered to the person, who became a plaintiff or defendant for another person, shall be binding on the said another person also.

(4) The provisions of paragraphs (1) through (3) shall apply *mutatis mutandis* to the pronouncement of provisional execution.

Article 248 of the Civil Procedure Act (Method of Institution of Lawsuit)

A lawsuit shall be instituted by filing a written complaint with a court.

【Reference Cases】 Supreme Court Decisions 87Daka1761 decided Nov. 10, 1987 (Gong1988, 97); 2005Da74764 decided Apr. 14, 2006; 2010Da61557 decided Oct. 28, 2010 (Gong2010Ha, 2176)

【Plaintiff-Appellee】 Seoul Guarantee Insurance Corporation (Law Firm Heonam, Attorneys Yoo Byeong-il et al., Counsel for the plaintiff-appellee)

【Defendant-Appellant】 Defendant

【Judgment of the court below】 Seoul Central District Court Decision 2017Na43304 decided January 31, 2018

【Disposition】 The final appeal is dismissed. The cost of the final appeal is assessed against the Defendant.

【Reasoning】 The grounds of appeal are examined.

1. <u>Inasmuch as a final and conclusive judgment in favor of one party has *res judicata* effect, where said party instigates a suit against the other party for</u>

a claim identical in the previous suit in which a final and conclusive judgment was rendered, the subsequent suit is unlawful as there is no benefit in the protection of rights. *Provided*, however, if the ten-year period of extinctive prescription is nearing its lapse time for a claim based on a final and conclusive judgment, there exists benefit of a lawsuit (*see*, *e.g.*, Supreme Court Decisions 97Daka1761, Nov. 10, 1987; 2005Da74764, Apr. 14, 2006).

Furthermore, given that the judgment of a subsequent suit cannot be incompatible with the final and conclusive judgment rendered in favor of one party in a prior suit, the competent court hearing the subsequent suit cannot re-examine whether all necessary requirements have been satisfied to assert such established right (*see*, *e.g.*, Supreme Court Decision 2010Da61557, Oct. 28, 2010).

2. The lower court acknowledged the following in full view of the admitted evidence. (i) Around December 1995, the Plaintiff and the Nonparty concluded an installment sale guarantee agreement (hereinafter "guaranteed insurance policy") stipulating the insured as Hyundai Motor Co., Ltd. (hereinafter "HMC"), the insurance subscription amount as KRW 9,504,000, the insurance period as December 27, 1995 to December 26, 1997, and the subject matter as an automobile (model: Sonata) installment payment obligation. The Defendant assumed joint and several liability for the entire obligation assumed by the Plaintiff based on the guaranteed insurance policy. (ii) When the Nonparty did not perform the installment payment obligation on three occasions, HMC charged the premium to the Plaintiff according to the guaranteed insurance policy and the Plaintiff subsequently paid KRW 7,600,951 to HMC on July 23, 1996. (iii) The Plaintiff instigated a suit seeking indemnification against the Nonparty and the Defendant (Seoul District Court 96Gaso439231) to which a judgment in favor of the Plaintiff was rendered on April 8, 1997 and said judgment became final and conclusive around that time. Thereafter, the Plaintiff was paid KRW 2,337,933. (iv) To extend prescription, the Plaintiff instigated a suit seeking indemnification (Seoul Central District Court 2007Gaso1135651). On February 1, 2007, the Seoul Central District Court handed down a decision of performance recommendation (regarding KRW 18,767,816 and KRW 5,263,018 of that amount, pay as interest computed at 18% per year from June 30, 2006 until the date of repayment), and the judgment became final and conclusive as is.

Based on this factual basis, the lower court held as follows: The Defendant, together with the Nonparty, is obligated to pay the Plaintiff the amount of KRW 18,767,816 as indemnification. As to the principal amounting to KRW 5,263,018 of the indemnified amount, based on the calculated annual interest computed by the Plaintiff, the Defendant and the Nonparty is obligated to pay delay damages based on the agreed-upon annual rate of 18% from June 30, 2006 to September 30, 2015 and based on the annual rate of 15% specified under the Act on Special Cases Concerning Expedition, etc. of Legal

Proceedings from the date following the aforementioned date until the date of full repayment.

Moreover, regarding the Defendant's assertion to the effect that "the Defendant does not assume an obligation according to the guaranteed insurance policy inasmuch as the Defendant did not know the Nonparty and had not concluded a joint and several liability agreement with the Plaintiff," the lower court held as follows: In the lawsuit seeking indemnification that the Plaintiff had instigated against the Defendant with the Seoul District Court (Docket No.: 96Gaso439231), insofar as the existence of an indemnification claim as seen above has been established, the Defendant's grounds asserted in the instant case for the interruption of extinctive prescription conflicted with the *res judicata* of the foregoing final and conclusive judgment, thus precluding its examination.

The determination of the lower court as above follows the legal doctrine, *supra*. Thus, contrary to what is alleged in the ground of appeal, the lower court did not err by misapprehending the legal doctrine, etc.

3. As above, <u>in cases where the ten-year extinctive prescription of a claim established by a previous final and conclusive judgment is nearing the lapse time, the Supreme Court has maintained the legal doctrine that there exists benefit in the re-instigation of a suit for interrupting prescription. This legal doctrine holds true even today. In regards to other causes interrupting prescription (such as seizure, provisional seizure or approval), the number of times in which such causes can be effectuated is not limited to one instance; thus, no rationale exists to deem that only a judicial claim ought to be limited to one instance. Also, insomuch as an obligation established by a final and conclusive judgment can be entirely or partly set-off through insolvency or rehabilitation proceedings, permitting an obligee to re-instigate a suit for the interruption of prescription is reasonable</u>.

Examining the record, there is a benefit in the re-instigation of the pertinent suit for interrupting prescription inasmuch as such lawsuit was filed again on August 19, 2016, a date nearing the expiration of the ten-year prescription period that had commenced on February 23, 2007 when the Seoul Central District Court rendered a final decision on performance recommendation in favor of the Plaintiff in the previous suit that was filed by the Plaintiff against the Defendant (Docket No.: 2007Gaso1135651).

4. Therefore, the final appeal is dismissed, and the cost of the final appeal is assessed against the losing party. It is so decided as per Disposition by the assent of all participating Justices with the exception of a dissent by Justices Kim Chang-suk, Kim Shin, Kwon Soon-il, and Park Sang-ok, followed by Opinions by Justices Kim So-young and Min You-sook concurring with the Majority and an Opinion concurring with the Dissent by Justice Kim Chang-suk.

5. Dissenting Opinion by Justice Kim Chang-suk, Justice Kim Shin, Justice Kwon Soon-il, and Justice Park sang-ok

A. According to the Majority, if an obligation has not been performed even after ten years had nearly passed following the judgment in favor of one party having become final and conclusive, the benefit in the protection of rights exists on the part of the obligee who can file a subsequent suit identical to the judgment regarding the previous suit. In short, the Majority permits re-instigation of a suit for interruption of prescription.

The Majority's position is premised on the fact that a claim established by a judgment ought to be kept from being extinguished due to prescription so long as the claim is not fully satisfied by means such as repayment. We dissent from this view as it contravenes the fundamental principle of the Civil Act that provides for the extinguishment of a claim and the extinctive prescription system and the doctrine of civil proceedings that acknowledges the *res judicata* effect of a final and conclusive judgment. Therefore, the Supreme Court precedent to which the Majority follows should be overruled.

B. Statutory provisions related to "extinction of claims" are stipulated in Part III, Chapter 1, Section 6 of the Civil Act but there is no separate section regarding "extinction of real rights" under Part II and matters related to "extinctive prescription" are provided for in Part I, Chapter 7 of the Civil Act. While extinctive prescription is applicable to all claims, this is not the case for most real rights such as right of ownership, right of possession, and security right (excluding superficies and servitude). Unlike real rights (absolute right), a claim is a relative right seeking cooperation of realization of right by asserting the performance of an obligation against the other party. Therefore, in cases where a claim is satisfied upon cooperation from the other party, including where further cooperation cannot be expected, there is a need to relieve said party from the obligation by extinguishing said right. For this reason, the Civil Act has provisions regarding repayment, deposit, set-off, etc. in which a claim extinguishes upon satisfaction as well as provisions on extinctive prescription in which a claim extinguishes due to a lapse of time irrespective of whether a claim is satisfied.

Article 162(1) of the Civil Act provides that "The extinctive prescription of a claim shall become complete if not exercised for a period of ten years." Articles 163 and 164 provides for the short-term extinction of claims such as one year or three years. Under Article 766 (Prescription in Respect of the Right to Claim for Damages) of the same Act, "The right to claim for damages resulting from an unlawful act shall lapse by prescription if not exercised within three years commencing from the date on which the injured party or his/her legal representative becomes aware of such damage and of the identity of the person who caused it" (Parag. (1)) and "The provisions of paragraph (1) shall also apply if ten years have elapsed from the time when the unlawful act was committed" (Parag. (2)).

A claim extinguishes upon completion of the extinctive prescription period. A claim is premised on a temporary nature that is based on "extinguishment" and the Civil Act also acknowledges the extinguishment of an unsatisfied claim. Therefore, in construing and applying the extinctive prescription system, this does not justify the need to prevent unsatisfied claims from extinguishing and to extend the maturity period until a claim is satisfied to prevent such extinguishment. Rather, the Majority Opinion to the effect that extinctive prescription ought to be prevented is inconsistent with the inherent nature of a claim and the provisions under the Civil Act.

C. The Civil Act basically sets the extinctive prescription period of a claim at ten years; however, for certain claims, a short extinctive prescription of one year or three years is stipulated depending on circumstances (e.g., hardened commercial practice in which payment occurs over a short period and the difficulty in keeping evidentiary documents for a prolonged period, such as receipts of small-amount claims that tend to frequently occur) and need to protect obligors through ensuring stability in legal relationship. Yet, if construed as prescription extension being possible without limit if judgment is rendered every ten years as to such claim, this would be deviating from the purpose of the short-term extinctive prescription system. In addition, Article 184(2) of the Civil Act provides that "Although extinctive prescription shall, by a juristic act, not be excluded, extended or aggravated, it may be shortened or lessened." That said, if a *de facto* permanent claim is acknowledged upon permitting the re-instigation of a suit for interrupting prescription, such would constitute a contravention of the aforementioned provision under the Civil Act.

Provisions related to extinctive prescription and prescription interruption are stipulated under the Civil Act. This is to balance the benefit between an obligee and an obligor by stabilizing the legal relationship and developing a mechanism to protect an obligee's right. The causes interrupting prescription under Article 168 of the Civil Act (i.e., demand, seizure or provisional seizure, provisional disposition, and approval) does not permanently interrupt prescription but rather, prescription begins to run anew from the date such cause ends pursuant to Article 178; *provided*, in the case of a judicial claim, a ten-year extinctive prescription period is newly recognized for all claims, even claims falling under a short-term extinctive prescription, upon a judgment becoming final and conclusive according to Article 165(1) of the Civil Act. Under the Civil Act, as to a judicial claim (one of the causes interrupting prescription), the extinctive prescription period that runs anew following the interruption of the original period is ten years, and does not provide that the extinctive prescription is renewed permanently if said judicial claim is repeated. Nevertheless, permitting a suit to be re-instigated for interruption of prescription forestalls the running of prescription itself that functions as a measure to achieve balance of benefit between an obligee and an obligor, thereby bringing about the reversal in cause and effect.

According to Article 162 of the Civil Act, the running of prescription of a claim is deemed obvious and ordinary, given the temporary nature of a claim, rather than regarding it as exceptional or abnormal. In view of the purport of the Civil Act that provides for extinctive prescription and interruption of prescription, this does not imply that a claim does not permanently extinguish via the repeated application of Article 165(1) without restriction that sets the prescription period of a claim established by a judgment at ten years and Article 168(1) that provides "demand" as the cause interrupting prescription. However, according to the Majority Opinion, even a claim that falls under a short-term extinctive prescription of one year can become a permanent claim if a judgment is rendered through instigation of a suit every ten years. This conclusion cannot be said to accord with the purpose of the extinctive prescription system under the Civil Act.

D. The Majority's view that permits the re-instigation of a suit for interruption of prescription contains insoluble conundrums even regarding *res judicata* effect.

The Supreme Court deems impermissible *res judicata* as the instigation of a subsequent suit that is identical to the subject matter of a previous suit to which judgment has *res judicata* effect (*see*, *e.g*., Supreme Court Decision 2000Da41349, Jan. 16, 2001). Inasmuch as a final and conclusive judgment in favor of one party has *res judicata* effect, if said party were to file a suit against the other party regarding a claim identical to the previous suit in which a final and conclusive judgment was rendered, the subsequent suit would be unlawful as no benefit in the protection of rights would exist barring exigent circumstances (*see*, *e.g*., Supreme Court Decision 2017Da23066, Nov. 14, 2017). In so determining, the Supreme Court declares the principle that where instigation of an identical suit by a party in which a final and conclusive judgment was rendered, no benefit of rights protection exists based on the *res judicata* of the judgment on the previous suit.

The Civil Act also merely stipulates that where the cause interrupting prescription (i.e., demand by judicial proceedings) occurred, prescription runs anew from the time a judgment regarding a claim becomes final and conclusive, and does not have a provision stipulating to the effect that prescription as to the same can be interrupted via seeking another judicial claim despite the *res judicata* effect against said claim. Rather, Article 170(1) of the Civil Act provides that prescription interruption is ineffective in cases where a judicial claim is dismissed on the grounds of unlawfulness. Therefore, re-instigation of a lawsuit for interruption of extinctive prescription relates to a final and conclusive judgment rendered in favor of one party and thus unlawful as there is no benefit of rights protection; accordingly, further interruption of prescription cannot be deemed feasible.

Nonetheless, solely on the basis that an unsatisfied claim should not be extinguished upon prescription, the Majority Opinion states that there is benefit of rights protection in extraordinary circumstances where extinctive prescription is nearing completion even if a final and conclusive judgment in favor of one party has been rendered. However, such foregoing construction goes against the purpose of the extinctive prescription system. The Majority's position in acknowledgement of benefit in the protection of rights on a different premise is merely a redundant argument that a claim should not be extinguished upon prescription.

Moreover, "where the period of extinctive prescription is nearing completion" as referred to in the Majority Opinion is vague. Does it mean one or two years are left until completion of prescription? In practice, if each judge were to determine the timing differently, this would result in legal instability and increase judicial proceeding costs. Furthermore, the Majority opines that in cases where the prescription period is not nearing its lapse time, no benefit in the protection of rights exists due to *res judicata* of a final and conclusive judgment even if an obligee instigated a suit for an identical purpose (interruption of prescription), and that such benefit incurs when completion of prescription nears. However, *res judicata* effect neither loses validity nor extinguishes upon the lapse of time; it rather refers to the permanent effectiveness of a judgment. From a logical standpoint, the sudden recognition of the benefit in the protection of rights as to a previous suit that was initially not recognized by *res judicata* is inexplicable.

A plaintiff, as an enforcement title holder upon having been rendered an enforceable judgment, does not possess a legal benefit of instigating an identical suit under the Civil Procedure Act. Pursuant to Article 170 of the Civil Act, so long as a legitimate judicial claim is deemed a cause interrupting prescription premised on the principle of the Civil Procedure Act, deeming that a judicial claim cannot be sought again when a final and conclusive judgment in favor of one party has already been rendered is logically consistent.

E. On the ground that "causes interrupting interruption" as defined under Article 168 of the Civil Act should be equally applied, some argue that a judicial claim can be sought more than once. However, among the causes interruption prescription, "approval' is indicative of an obligor's intent to perform his/her obligation and should not be restricted. Conversely, other causes not based on an obligor's intent (namely, judicial claim, seizure, provisional seizure, and provisional disposition) fall under a litigation act; thus, validity is recognized only in cases of a legitimate litigation act and the same is also provided for in Article 170 of the Civil Act. Similar to where an identical suit cannot be filed in the event an effective judgment in favor of one person was rendered, should there be a valid seizure, provisional seizure or provisional disposition, then seeking effectuation of the same cause would be unlawful and thus impermissible. Permitting seizure of another property given that an obligor's property that had already been seized was only partially collected is the same as permitting the remainder of claims following a judgment as to the claim specifying the partial seizure, and therefore deemed lawful under the Civil Procedure Act. Also, inasmuch as a peremptory notice is not an act under the

Civil Procedure Act, an obligee's repetitive peremptory notice cannot be derailed as a matter of course on the ground of unlawfulness. However, Article 174 of the Civil Act acknowledges the effectiveness of a peremptory notice in interrupting prescription only in cases where a judicial claim is sought within six months. In short, Article 174 of the Civil Act strictly provides that the effectiveness of the interruption of prescription shall not be repeatedly acknowledged regardless of the number of times peremptory notice was given. In that sense, we point out that proscribing the re-instigation of a suit does not mean that "demand by judicial proceedings (judicial claim)" is treated differently with other causes interrupting prescription as defined under Article 168 of the Civil Act.

F. If the existence of a permanent claim were to be acknowledged by permitting a suit to be re-instigated for interrupting prescription, this would incite rampant debt collection practices and thus lead to social problems, i.e., imposing heavier debt burden on the economically marginalized who lack debt repayment capacity.

Following the Majority's logic would result in enabling an obligee to undergo debt collection against an obligor and the obligor's family through debt transfer/inheritance, etc. merely by instigating a suit every ten years. Various statistics show the low feasibility in the repayment of debt that has been long overdue. Although the repaid amount is substantial for an individual, the need to reasonably weigh the benefit accrued from repayment with the social costs incurred from repetitive suits every ten years and the suffering of obligors due to debt collection cannot be disregarded.

If a claim cannot be compulsorily enforced, extinguishing a claim can be considered to ease an obligee from the burden of having to re-instigate a suit; remove legal uncertainty by ensuring an obligor's trust in the extinctive prescription of a claim; and protect the economically marginalized by severing the vicious cycle of subsequent default transfers and unlawful debt collection practices.

Moreover, even if the re-instigation of a lawsuit for interrupting prescription is impermissible, an obligee can collect a claim during the maximum period of fifteen or twenty years, that is, the ten-year period of extinctive prescription that runs anew due to interruption by a judicial claim added to the basic period of extinctive prescription. Given that most property transactions take place electronically, tracing such transactions is easy, legal procedures are in place to identify property that is subjected to compulsory enforcement (i.e., property disclosure and inquiry), and an obligee's revocation lawsuit is being widely used. In view of these circumstances, the foregoing period is not short for an obligee to exercise his/her right. If there are concerns that an obligee may not be well protected due to said period being short, the cause can be found in the Civil Act that sets the period of extinctive period of a claim established by a judgment at ten years; thus, the matter ought to be resolved from a legislative standpoint. Disproving the re-instigation of a lawsuit for interrupting prescription is properly construing and applying the extinctive prescription system as intended by the Civil Act, and does not imply exempting a malicious obligor's debt by introducing a new system.

In this case, the Plaintiff's claim against the Defendant occurred around July 1996. The Plaintiff instigated the suit in 1996 and was rendered a favorable judgment. In 2007, the Plaintiff filed a second suit and the competent court handed down a final decision of performance recommendation. The pertinent suit is the third to be instigated in 2016, which is around the lapse time of the ten-year period from the date when the decision of performance recommendation was rendered. Twenty years have passed since the first claim occurred. What is the likelihood of the Plaintiff receiving the principal amount of KRW 5,263,018 and delay damages from the Defendant, which had not been paid for twenty years, by extending the prescription period for another ten years? Even if a fourth suit were to be filed after another ten years transpires, the Plaintiff may have to continuously instigate a lawsuit every ten years onwards against the Defendant's heir. As the prescription is not completed should a suit be filed every ten years, the Plaintiff, even if aware that he may not be repaid, may be placed in a situation where instigating a suit every ten years is inevitable at the risk of costs due to regulatory violations or audits, etc. This is obviously not an ideal situation for all concerned.

G. The Plaintiff in the instant case already filed a suit and was rendered a decision of performance recommendation that has the same effect as a judgment, but thereafter filed another suit for interrupting prescription near the ten-year lapse period. Inasmuch as the pertinent suit is identical to the previous suit in which a final decision of performance recommendation was handed down, no benefit in the protection of rights exists and is thus unlawful. Nonetheless, the lower court accepted the Plaintiff's claim on the merit. In so doing, it erred by misapprehending the legal doctrines related to extinctive prescription and interruption of prescription, *res judicata* effect of a final and conclusive judgment, and benefit in the protection of rights. Therefore, the lower judgment should be reversed.

As above, we express our Dissent from the Majority Opinion.

6. Opinion concurring with the Majority Opinion by Justice Kim So-young and Justice Min You-sook

A. The Dissenting Opinion can be construed to the effect that a suit cannot be re-instigated once a final and conclusive judgment has been rendered. However, as seen in the foregoing precedent (*see*, *e.g.*, Supreme Court Decision 2005Da74764, Apr. 14, 2006), the Supreme Court has consistently ruled that "where the ten-year extinctive prescription period of a claim based on a final and conclusive judgment is nearing the lapse time, there exists the benefit of lawsuit for interrupting prescription." The Justices Dissenting opine that said precedent should be overruled, but the legal doctrine thereof should be maintained.

B. Permitting the re-instigation of a suit for interrupting prescription cannot be deemed as going against the purpose of the extinctive prescription system.

(1) Extinctive prescription under the Civil Act is not a system that "exempts an obligor by extinguishing a claim in which performance cannot be expected" (Section B of the Dissenting Opinion) but rather, a system seeking to balance the benefits between an obligee and an obligor by acknowledging the interruption of prescription. The pertinent suit was instigated by the obligee to interrupt the extinctive prescription, which is one's right, due to the nonperformance of the claim that was established by a judgment.

The Dissent can be understood to the effect that, among the causes interrupting extinctive prescription under Article 168 of the Civil Act, "approval" (Subparag. 3) can be sought several times while judicial claim (Subparag. 1) and seizure, provisional seizure or provisional disposition (Subparag. 2) cannot if a final and conclusive judgment had been previously rendered or if there exists a prior seizure, etc. (Section E of the Dissenting Opinion). However, similar to the premise in the Dissent, the extinctive prescription system under the Civil Act follows the provisions under Party I, Chapter 7 of the same Act. The Civil Act stipulates matters related to the period of extinctive prescription, causes interrupting prescription, and effectiveness of prescription but does not have a provision limiting the number of times in seeking effectuation of the causes as *supra*. Rather, as seen *infra*, the Civil Act has a provision for interrupting extinctive prescription more than once, and judicial precedents are also premised thereto.

Interruption of extinctive prescription falls under an obligee's exercise of his/her right. Limiting such right without any legal basis is unreasonable. The same is all the more true where the scope of rights exercise is limited to a judicial claim that is stipulated as one of the causes interrupting extinctive prescription under the same legal text.

(2) In the event an obligor-owned property was effectively confiscated but the relevant claim was only partially collected as a result of execution and time had elapsed, an obligee may again interrupt the extinctive prescription by seizing another property of the obligor. Such attempt to realizing rights is not proscribed.

If a peremptory notice of performance was given to an obligor but time has passed without the obligor's voluntary performance, an obligee may issue another peremptory notice to obtain the effectiveness of interrupting extinctive prescription. *Provided*, however, a peremptory notice is subject to the limitation of Article 174 of the Civil Act that provides that the interruption of prescription is ineffective unless a judicial claim, etc. is sought within six months. Therefore, if such judicial claim is sought after having issued several peremptory notices, the interruption of prescription is effectuated upon the peremptory notice given within six months based on retroactive application from the point when said claim was made (*see* Supreme Court Decision 87Daka2337, Dec. 22, 1987). Whether "demand" (one of the causes interrupting prescription under the Civil Act) is a litigation act under the Civil Procedure Act does not vary depending on the limitation of times a demand can be sought.

In practice, however, there is difficulty in finding a cause to re-demand the interruption of extinctive prescription in provisional seizure. This is not because such provisional seizure is impermissible but because there is no need to repeat provisional seizures for interrupting prescription given that the effectiveness of the same continues during the period when the preservation of enforcement by provisional seizure remains effective (*see*, *e.g.*, Supreme Court Decision 2000Da11102, Apr. 25, 2000).

C. We fully agree with the following points raised in Section F of the Dissenting Opinion: (i) the suffering of the economically marginalized increases due to the rampant debt collection practice; and (ii) the suffering of obligors due to endless debt collection, debt inheritance, etc. should not be ignored. However, as seen below, the foregoing problems need to be resolved via another system or specifying the criteria for acknowledging the benefit in the protection of rights as to re-instigating a suit for interrupting prescription. We do not agree with the Dissent's position that an obligor can only be protected by proscribing the re-instigation of a suit for interruption of prescription itself.

(1) In principle, the means for an obligor in default to relieve oneself from debt is through the bankruptcy or rehabilitation proceedings as prescribed by the Debt Rehabilitation and Bankruptcy Act. Decent individuals may find themsevles in default due to unintentionally having assumed excessive debt burden while engaging in economic activities. In such case, the individuals can partly repay their debt and have the outstanding debt written off through the individual rehabilitation program; if that is impossible, such individuals can file for bankruptcy to have their debt entirely written off. These procedures can ensure equity among obligees. Courts need to assist individuals in a default state to liquidate their debt within the realm of law and have the chance to resume economic activities by resorting to the aforementioned bankruptcy and rehabilitation proceedings.

Moreover, in relation to a deceased parent's debt inheritance, the Civil Act has a system to waive such inheritance or approve the same with restriction. Courts ought to actively utilize this system so that the younger generation is not discouraged by inheriting debt.

Meanwhile, statutes such as the Act on Registration of Credit Business, etc. and Protection of Finance Users and the Fair Debt Collection Practices Act (hereinafter "Debt Collection Act") have several provisions on protecting obligors by preventing unlawful debt collection practices by money lenders, etc.

Of note, the Debt Collection Act proscribes acts using deception or force as well as acts disrupting an individual's personal life by causing fear or anxiety, and also has a penal provision upon violation (*see* Articles 9 and 15). A court should exercise strict penal authority as to an unlawful act of debt collection. Furthermore, a heavier sense of responsibility may be bestowed on a State based on affirmative interpretation of the duty to make effort to protect an obligor or related parties from misuse of the right of debt collection or unlawful acts of debt collection (*see* Article 3).

As can be seen, regarding an obligor, albeit lacking in ability or skill but with intent to faithfully perform an obligation that he/she assumes by a final and conclusive judgment, there is a mechanism in place to encourage performance of an obligation through a reasonable procedure and scope and protect an obligor from an obligee's excessive pressure. Conversely, proscribing re-instigation of a suit for interruption of prescription itself, which would deny the exercise of right by a faithful obligee unable to realize the right acknowledged by a final and conclusive judgment and concomitantly exempt an obligor who has hidden property and refusing performance of obligation from assuming the obligation by a final and conclusive judgment, should not occur.

(2) To protect obligors, the Supreme Court should focus on setting criteria that would sufficiently examine the conditions for recognition of the benefit of rights protection that is presented in judicial precedents as a requirement for interruption of prescription on a case-by-case basis.

Fact-finding court judges are already providing necessary relief for obligors through sufficient deliberation on whether "completion of extinctive prescription" (requirement to determine the benefit of lawsuit) has occurred in cases involving re-instigation of suit for interruption. The Justices Dissenting argue that "varying judgments by judges would only cause legal instability" but, as to whether benefit of rights protection ought to be recognized, the specific circumstances of each individual case ought to be taken into consideration. Of course, going forward, the Supreme Court needs to further concentrate on increasing the predictability of a trial by rendering judgment grounded in a more specified standard.

D. We return to the instant case.

(1) The business purpose of the Plaintiff, a credit guarantee institution offering various services necessary for commercial transaction, is engaged in the insurance business (such as guaranteed insurance and credit insurance) pursuant to the Insurance Business Act and the relevant debt collection business. The Plaintiff centers on issuing guaranteed insurance certificates regarding a wide range of transactions (including the pertinent automobile installment sale), pays the premium upon occurrence of an insured event, and collects the premium paid from related parties by law and contract.

After having been rendered a favorable final and conclusive judgment in the first suit (Seoul District Court 96Gas043921) as seen above, the Plaintiff underwent a compulsory auction of the land owned by the Defendant but was only allocated 6% of the claim due to the existence of senior creditors. Upon the nearing of ten years since the first lawsuit, the Plaintiff instigated a second suit in 2007 and the competent court handed down a final decision of performance recommendation as there was no contest plea by the Defendant. In 2003, an order for seizure and collection was issued upon the Plaintiff having discovered the Defendant's insurance policy, but the seizure was lifted when the Defendant filed a complaint asserting old age and health problems. When another ten years approached since the second lawsuit, the Plaintiff instigated a suit in 2016 for the interruption of prescription. In response, the Defendant made repeated allegations, from the first instance trial to the final appellate trial, that the document related to joint and several surety submitted by the Plaintiff was forged, an allegation that was blocked based on the *res judicata* of the final and conclusive judgment as to the first suit.

(2) Examining these facts in light of the foregoing legal doctrine, there is no need to proscribe the instigation of a suit (in connection to the performance of a company's business) or extinguish the enforcement title as argued in the Dissent.

Ultimately, the instant suit was instigated near the ten-year lapse from the final decision on performance recommendation, and thus, the benefit of a lawsuit exists.

As above, we express our Concurrence with the Majority Opinion.

7. Opinions by Justice Kim Jae-hyung and Justice Cho Jae-youn concurring with the Majority

The Dissenting Opinion's negation of re-instigating a suit for interruption of the extinctive prescription of a claim in which a final and conclusive judgment was rendered is not acceptable under Korea's legal system. Our reasoning is explicated below.

A. Deeming a right that was actively exercised to be extinguished by extinctive prescription neither accords with the inherent nature of extinctive prescription system nor the relevant provision under the Civil Act.

Extinctive prescription is a system under which a legal effect occurs (that is, extinguishment of a right) in cases where a rights-holder does not exercise his/her due right for a certain period. For the completion of extinctive prescription, a *de facto* state (namely, non-exercise of right) ought to continue for a certain period.

The extinctive prescription of a claim shall become complete if not exercised for a certain period (*see* Articles 162-164 of the Civil Act). An additional requirement for the completion of prescription is that non-exercise of a right continues for a certain period, rather than the extinguishment of a right due to the passage of time. The running of extinctive prescription is interrupted if a factual event occurs that forestall non-exercise of right, which serves as the basis for extinctive prescription. Article 168 of the Civil Act provides for causes interrupting extinctive prescription, i.e., demand (Subparag. 1), seizure or provisional seizure and provisional disposition (Subparag. 2), and approval (Subparag. 3). The foregoing causes are stipulated as grounds for interruption given that they reverse the *de facto* state that serves as the basis for extinctive prescription, i.e., non-exercise of right.

The Justices Dissenting opine that, regarding a claim established by a judgment, the completion of extinctive prescription ought to be acknowledged depending on whether the ten-year period has lapsed rather than whether the non-exercise of right has continued for ten years. We do not agree as the Dissent only focuses on only one requirement for the completion of extinctive prescription (that is, lapse of a certain period) and disregards the other requirement (that is, non-exercise of right).

B. Permitting the re-instigation of a suit for interrupting prescription does not contravene the *res judicata* effect of a judgment as to a previous suit.

(1) Articles 216 and 218 of the Civil Procedure Act provide for the objective and subjective scope of *res judicata* and no provisions exist as to its meaning, and thus the statutory provisions remain open to interpretation. Inasmuch as *res judicata* is binding to a final and conclusive judgment, a party may not assert otherwise and a court may not hand down an incompatible ruling where the existence or absence of a right or legal relationship that is an issue in a lawsuit and a final and conclusive judgment was rendered with respect to the issue in a previous suit between the same parties (*see* Supreme court Decision 89Nu1308, Oct. 10, 1989).

The same Act does not stipulate as to whether a subsequent suit can be filed in which the conclusion of the previous suit and the subject matter of suit is the same based on the *res judicata* of the conclusion as to the previous suit. Thus, the matter ought to be approached from the perspective of "benefit of lawsuit." This is similar in context to the Supreme Court's consistent ruling that "inasmuch as there exist *res judicata* effect to a final and conclusive judgment, where a party who was rendered a favorable judgment files a suit for a claim identical to that in which a final and conclusive judgment was rendered against the same party in the previous suit, the subsequent suit is unlawful as there is not benefit of rights protection barring exigent circumstances (*see*, *e.g.*, Supreme Court Decision 2017Da23066, Nov. 14, 2017). A subsequent suit in which the judgment as to a previous suit and the subject matter of the suit is the same is bound to be handed down a similar judgment based on *res judicata* of the judgment to the previous suit. Therefore, a subsequent suit in principle should not be permitted as there is no substantive benefit to acknowledge the same. However, if there exists an extraordinary circumstance to instigate a subsequent suit, then it ought to be permitted as there is benefit of rights protection.

The Dissent opines that "an explicit provision should be established to proscribe the instigation of a subsequent suit identical to the previous suit based on *res judicata* effect." Yet no obvious reason exists to deem as such. This matter can be resolved by determining whether the benefit of rights protection exists in instigating a subsequent suit.

(2) As seen above, *res judicata* avoids incompatible conclusions between a previous and subsequent claim, thereby prevents unnecessary lawsuits. Should there be a need to file a subsequent suit and doing so would not bring forth any inconsistency in conclusion, no reason would exist to block the subsequent claim on grounds of the *res judicata* of the conclusion as to the previous suit. Re-instigation of a suit interrupting prescription is a typical example.

There are a number of cases where an obligee is unable to obtain satisfaction even after having received a final and conclusive judgment. Cases exist where an obligor's whereabouts are unknown or property is non-traceable due to concealment of said property, and thus holding the obligee liable is not possible. If a claim is not satisfied near the lapse of ten years (extinctive prescription period of a claim upon a final and conclusive judgment), "judicial claim" is the only means to interrupt prescription barring special circumstances. In such case, from the standpoint of an obligee, there is need to instigate a subsequent suit despite having been rendered a favorable judgment as to the previous suit.

To this, the Dissenting Opinion says that an obligee's benefit of rights protection should be denied to protect an obligor; however, this is difficult to accept. As a matter of principle, an existing right should be protected by law. The purpose of the extinctive prescription system is to not warrant protection for those who do not exercise their existing rights for a prolonged period. Under the fundamental judicial order, "an obligee who seeks to exercise his/her right" should be better protected than "an obligor who does not perform his/her obligation." If protection of right is prevented using *res judicata* effect, this would discord with the right to property guaranteed under the Constitution or the purpose of the *res judicata* system.

C. As the cause interrupting extinctive prescription, "judicial claim" cannot be deemed as being limited to one instance.

(1) Article 165(1) of the Civil Act provides that the period of extinctive prescription of a claim established by a judgment shall be ten years, even where the period for the original claim is shorter. Article 168 of the same Act stipulates three causes interrupting extinctive prescription — (i) demand, (ii) seizure or provisional seizure and provisional disposition, and (iii) approval — and has other provisions related to other causes interrupting prescription. Similar to other causes interrupting prescription, there is no limit to seeking a judicial claim. This problem ought to be resolved depending on whether there exists

benefit in the protection of rights to instigate a subsequent suit in relation to the *res judicata* of a judgment to a previous suit.

(2) According to the Dissent, inasmuch as the temporary nature of a claim that is a relative right, a right should be extinguished even in cases where further cooperation cannot be expected from an obligor and doing so accords with the extinctive prescription system. This is also difficult to accept.

A claim, a right to demand a certain act from an obligor, is an exclusive right in which benefit is obtainable through direct control of a specific object and possesses a trait distinguishable from right *in rem* that is exercisable by all. Be that as it may, no rationale exists to deem temporariness as a trait that sets a claim apart from a right *in rem*. Other than property rights, claims as well as real rights shall become complete if not exercised for a certain period (*see* Article 162(2) of the Civil Act).

Also, where cooperation or performance cannot be expected from an obligor, the Dissent's premise that a claim ought to be extinguished is not sustainable. If an obligee cannot expect cooperation and a suit is filed against an obligor and compulsory enforcement is sought based on the enforcement right (such as a final and conclusive judgment), a State is obligated to ensure that the obligee's right is realized through such procedures. Given the nature of a claim, the object is unattainable without an obligor's voluntary performance; accordingly, a claim for damages can be filed even where such performance cannot be enforced. In any case, a claim against an obligor cannot be deemed as extinguished.

Barring exigent circumstances, law should be construed in the direction of protecting rights. Just because a claim is a relative right that can be sought against a specific party, the interpretation to the effect that "an obligation established by a judgment is extinguished and exempt if ten years passes without repayment" is not justifiable.

(3) There is no reason to protect a claim established by a judgment lesser than a claim not established by a judgment. Insofar as an obligee protects his/her right, it is appropriate to do so in any case.

The Dissent is based on the premise that the provision on interruption due to a judicial claim is inapplicable toward a claim established by a judgment. This is incompatible with applying said provision to a claim not established by a judgment. In any case, a judicial claim ought to be deemed as suspending the *de facto* state of non-exercise of right; however, the Dissent says that interruption of prescription through a judicial claim is impermissible as to a claim established by a judgment and thus unreasonable.

D. Albeit the re-instigation of a suit against a claim established by a judgment is permitted, it cannot be deemed as contradicting Article 184(2) of the Civil Act that is cited as one of the reasoning by the Dissenting Justices.

Article 184(2) of the Civil Act provides, "Although extinctive prescription shall, by a juristic act, not be excluded, extended or aggravated, it may be shortened or lessened.” This is a revision of the principle of the freedom of juristic act so that, as desired by an actor, extinctive prescription cannot be excluded, extended or aggravated through an effective juristic act.

Even as to claims falling under a short-term extinctive prescription, the period of extinctive prescription is set at ten years if such claim is established by a judgment according to Article 165(1) of the Civil Act. Thus, no relation exists with the exclusion, extension or aggravation of extinctive prescription by a juristic act proscribed under Article 184(2) of the same Act.

Moreover, inasmuch as a judicial claim is a cause interrupting prescription and not a juristic act, it cannot be deemed as contradicting Article 184(2) thereof.

E. Under our Civil Act, the extinctive prescription period of a general claim and a claim established by a judgment is the same (ten years), but other countries set a longer period for a claim established by a judgment. Germany sets the extinctive prescription period at three years for general claims (Article 195 of the German Civil Code) and at thirty years for claims established by judgment (Article 197(1) of the same). According to the French Civil Code, the period is set at five years for general claims (Article 2224) and ten years for claims established by judgment (Article 111-4). According to the Principles on European Contract Law (PECL) — announced by the Commission on European Contract Law for the unification of different contract laws in Europe — sets the prescription period at three years for general claims (Article 14:201) and ten years for claims established by judgment (Article 14:202 Parag. (1)). As can be seen, even in countries that set a longer extinctive prescription period for claims established by judgment, re-instigation of a suit for interruption of extinctive prescription is not proscribed.

Furthermore, there are cases where judicial claim is specified as the cause for tolling the original period of prescription rather than the cause interrupting prescription. Yet, if a judgment becomes final and conclusive by a judicial claim, the statutory provision on claims established by judgment is applied; thus, no substantive gap exists between cases where a judicial claim is considered the cause for tolling the original period of prescription and the cause for interrupting prescription.

Unlike general claims, claims established by judgment entail the risk of the existence or amount of claim becoming uncertain as time elapses. Proscribing the instigation of a subsequent suit for interrupting extinctive prescription of a claim established by a judgment is inappropriate when the prescription period is set at ten years for both general claims and claims established by judgment. Inasmuch as an obligee clearly demands performance of an obviously existing claim and an obligor knows that the relevant obligation has to be performed, granting interruption of prescription to an obligee accords with the principle of justice.

F. There exist measures, such as the bankruptcy proceedings, under the civil law system for large-sum obligors to relieve themselves from debt that they are unable to repay.

The Dissenting Justices express concern that permitting re-instigation of a suit for interruption of prescription may disable an obligor (economically marginalized) from escaping the debt trap. However, extinctive prescription is not a system that exists to protect the economically marginalized. Just as all obligees are not economically strong, all obligors are not economically weak. If the *de facto* state of non-exercise of right continues for a certain period, the extinctive prescription system merely respects such state and acknowledges the legal effect of extinguishment of right. Applying the logic of the need to protect the weak by categorizing obligees and obligors as above toward the utilization of the extinctive prescription system does not accord with the purpose of the same.

The matter of excessive debt should be resolved through bankruptcy proceedings rather than the extinctive prescription system under the Civil Act. An obligor can be relieved from debt that cannot be repaid through bankruptcy proceedings.

Immediately following the enactment of the Civil Act, the Bankruptcy Act, the Composition Act, and the Company Reorganization Act was enacted. The three statutes were repealed as of April 1, 2006 and the Debtor Rehabilitation and Bankruptcy Act entered into effect, thus enabling wider use of the individual bankruptcy program. An individual can also be entirely or partly relieved of debt through bankruptcy or rehabilitation proceedings. In the event of an obligor's death, there are also mechanisms in place for an inheritor to waive his/her right to debt inheritance or assume limited liability of the obligor's property through approval with restriction. There are ways for an obligor to be relieved of excessive debt through the foregoing measures. Protecting an obligor by means of proscribing the re-instigation of a suit for interruption of prescription is not the right path.

G. Permitting the re-instigation of a suit for interrupting prescription may entail such problems as dual enforcement, unnecessary litigation costs, use of unfair means to collect debt, and rampant debt collection practices.

However, this may be taking issue as to how to determine the form of instigating a suit for interrupting prescription and the related litigation cost; the extent of the means of allegation/defense permissible in the litigation proceeding for interrupting prescription; and how to protect an obligor or related party based on the Debt Collection Act in the event debt collectors abuse their right or use illegal methods, but cannot serve as the basis for proscribing re-instigation of a suit for prescription interruption.

Rather, there is need to seriously consider whether the Dissent Opinion's conclusion (on the grounds that an obligee was rendered a final and conclusive judgment upon actively exercising his/her right, even if unable to obtain a satisfactory claim, a claim extinguishes as the re-instigation of a suit for interruption of prescription is proscribed when ten years passes from that time onward) accords with the layman's legal sentiment and impact on the general public's economic life.

As above, we express our Concurrence with the Majority Opinion.

8. Opinion concurring with the Dissenting Opinion by Justice Kim Chang-suk

A. Article 168 Subparag. 1 of the Civil Act provides "demand by judicial proceedings (judicial claim)" as the cause interrupting extinctive prescription. Article 165(1) thereof stipulates, "The period of extinctive prescription of claims established by a judgment shall be ten years, even where the period for the original claim is shorter under the Act." According to Article 178, "Where a prescription is interrupted, the period of prescription passed until the interruption shall not be computed, and the prescription which was interrupted begins to run anew from the time when the cause of such interruption has ceased to exist" (Parag. (1)) and "Prescription which was interrupted by a demand by judicial proceedings begins to run anew from the time when the judgment thereon becomes finally binding in accordance with the provisions of the preceding paragraph" (Parag. (2)).

Premised on the foregoing statutory provisions, the Majority Opinion says that even if the ten-year extinctive prescription has begun to run anew, the interruption of prescription can be repeatedly effectuated if a suit is instigated for a claim established by a judgment prior to the lapse of the same.; conversely, the Dissent opines that such construction would be acknowledging those claims as permanent claims, which goes against the nature of a claim and the purpose of the prescription system.

B. The Civil Act does not explicitly provide whether the interruption of prescription is repeatedly effectuated if a suit for interruption is instigated for a claim established by a judgment before the ten-year prescription period that has run anew passes; thus, the matter is left to be decided from an interpretative standpoint.

Yet the Majority Opinion and the Concurring Opinions (hereinafter simply referred to as "Majority Opinion") says that, if a lawsuit was filed for the interruption of prescription prior to the lapse of the prescription period of a claim established by a judgment, an obligee is deemed as having clearly exercised his/her right and thus the effectiveness of the completion of extinctive prescription should not be recognized. Furthermore, inasmuch as the existence or scope is clearly determined as to claims established by judgment, asserting that determination of the existence and scope of a claim is difficult due to the passage of time is contradictory. In that sense, the Majority Opinion appears to deem that no reason exists to prevent the continuous realization of such established right.

The Majority Opinion can be construed as adhering to the conventional view regarding the extinctive prescription system without restriction. Such position cannot be deemed as either reasonable or justifiable. Nor can it be deemed an inevitable interpretation of the current Civil Act as seen in the Dissenting Opinion.

C. According to Chapter 14, Section 3 of the PECL, the prescription period of claims established by judgment is set at ten years (as to the reckoning of the period of prescription, the PECL has a provision similar to that of Article 178(2) of our Civil Act); on the other hand, an attempt or approval of compulsory enforcement is acknowledged as the cause for the prescription period to run anew as to a claim established by a judgment whereas a judicial claim is only recognized as the cause for tolling the original period of prescription. This has been either adopted or will be adopted in the civil laws of European nations including Germany.

The foregoing provision of the PECL can be construed as an attempt or approval of compulsory enforcement (cause that is likely to bring about the realization of a claim), excluding a judicial claim, being acknowledged as the cause for the period of extinctive prescription to run anew as to claims established by judgment. This completely accords with the Dissent.

Ultimately, focus is shifting towards a new perspective on the extinctive prescription system, and there is no need to adhere to the conventional view on the rationale for the existence of said system, i.e., “non-exercise of right” or “difficulty in determining the existence and scope of a claim due to passage of time.” The Majority appears to lack in reasoning on this point whereas the Dissent is deemed more tenable.

As above, I express my Concurrence with the Dissenting Opinion.

Chief Justice	Kim Myeongsu (Presiding Justice)
Justices	Ko Young-han
	Kim Chang-suk
	Kim Shin (Justice in charge)
	Kim So-young
	Jo Hee-de
	Kwon Soon-il
	Park Sang-ok
	Lee Ki-taik
	Kim Jae-hyung
	Cho Jae-youn
	Park Jung-hwa
	Min You-sook

Supreme Court Decision 2017Da225084 Decided July 26, 2018【Decision on Enforcement】

【Main Issues and Holdings】

[1] Governing law for determining the establishment of an arbitral agreement and its validity under Article 5(1)(a) of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards

[2] Meaning of Article 5(1)(e) of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards

Whether the said provision can be deemed to have precluded filing of claims for enforcement decision in enforcing country on the ground that the country where arbitrary award was given rendered an affirmative decision (negative)

【Summary of Decision】

[1] According to the latter part of Article 5(1)(a) of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (hereinafter “New York Convention”), one of the grounds for refusing recognition and enforcement of arbitral awards is when the pertinent arbitral agreement is invalid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made. According to the provision *supra*, the governing law for determining the establishment of an arbitral agreement and its validity would primarily be the law to which the parties have subjected the said agreement, and where there exists no indication thereon, the law of the country where the award was made.

[2] The New York Convention removed the need for double enforcement decision or double exequatur by stipulating that an arbitral award has to become binding on the parties (Article 5(1)(e)), instead of requiring proof of finality of the award. It means that the party applying for recognition and enforcement of foreign arbitral awards may obtain a decision of enforcement in a country where the said party seeks the enforcement, instead of applying for separate procedures, such as enforcement decision or declaration of enforceability. The purport of this pertinent provision may not be construed as having prohibited filing of claims for enforcement decision in the enforcement country on the ground that the country where the arbitrary award was given rendered an affirmative decision.

【Reference Provisions】 [1] Article 5(1)(a) of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards [2] Article 5(1)(e) of the Convention on the Recognition and Enforcement of Foreign Arbitral

Awards

Article 5 of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards

1. Recognition and enforcement of the award may be refused, at the request of the party against whom it is invoked, only if that party furnishes to the competent authority where the recognition and enforcement is sought, proof that:

(a) The parties to the agreement referred to in article II were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made; or

(e) The award has not yet become binding on the parties, or has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made.

【Reference Case】 Supreme Court Decision 2012Da84004 decided Mar. 24, 2016 (Gong2016Sang, 601)

【Plaintiff-Appellee】 Crain Walnut Shelling Inc. (Law Firm Jipyung, Attorneys Kim Seung-hyun et al., Counsel for the plaintiff-appellee)

【Defendant-Appellant】 Shany Inc. (Law Firm Namsan, Attorneys Lee Chang-gu et al., Counsel for the defendant-appellant)

【Judgment of the court below】 Seoul High Court Decision 2016Na2040321 decided April 4, 2017

【Disposition】 The appeal is dismissed. The cost of appeal is borne by the Defendant.

【Reasoning】 The ground of appeal is examined.

1. Overview of the case

According to the reasoning of the lower judgment invoked partially by the lower court, and the record, following facts are revealed.

A. Beginning of the dispute

(1) The Plaintiff is incorporated in the United States of America (hereinafter “U.S.”), established in the state of California with the purpose of processing and selling walnuts. The Defendant is incorporated in the Republic of Korea, established with the purpose of processing and selling bakery products.

(2) In 2010, while pursuing long-distance trade, the Plaintiff and the Defendant entered into a contract where they agreed to exchange proposals and purchase orders via e-mail, and fulfilled their duties pursuant to the contract, that is, supplying walnuts and making payments. The Plaintiff and the Defendant signed on a spot contract, in which the Plaintiff was obliged to supply walnuts to the Defendant on two occasions, February and April 2010

respectively. The products were supplied and payment thereto was made according to the agreement.

(3) The Plaintiff and the Defendant argued over the proposal on yearly volume (hereinafter “instant proposal”), signed on March 19, 2010; while the Plaintiff claimed the walnut supply contract (hereinafter “instant contract”) entered into force, the Defendant refuted the instant contract did not become valid by its express statement, made on August 27, 2010, of not wanting to receive walnuts.

B. Content of litigation brought by the Plaintiff

The Plaintiff filed three lawsuits against the Defendant, seeking compensation for damages incurred by the Defendant’s failure to implement the instant contract. The Plaintiff (a) filed a request with the International Chamber of Commerce International Court of Arbitration (hereinafter “International Court of Arbitration”); (b) sought the enforcement of judgments before a U.S. court; and (c) sought the enforcement of judgments on the arbitral decision and the parts of the U.S. court decision before a Korean court. The Plaintiff obtained an arbitral judgment from the International Court of Arbitration and trials from a U.S. court. The instant case is concerned with seeking an enforcement decision on the arbitral award in question and the parts of the U.S. court decision (which is part of money judgment ordering the Plaintiff to make payment to the Defendant and is distinct from the part where the U.S. court approved of recognition and enforcement of the arbitral award given by the International Court of Arbitration) before a Korean court.

C. Gravamen of the instant case and order of determination

The gravamen of the instant case pertains to whether or not an arbitral agreement in writing was included in the instant contract. One must determine whether the provision on arbitral agreement under the terms and conditions of the instant case, which is referred to in the instant proposal, became part of the contract. This determination must be preceded by a decision of the governing law to be applied in regard to the establishment and efficacy of arbitral agreements.

Insofar as Nonparty 1 (whose Korean name appears to be [omitted]), responsible for procurement on behalf of the Defendant, engaged in the instant contract, one must confirm (a) whether Nonparty 1 was authorized to represent the Defendant; and (b) whether or not apparent representation was established. Once the instant contract is deemed valid, the next thing to ascertain is (a) whether the standard terms and conditions in the instant case, which are referred to in the instant proposal, became part of the contract; and (b) whether arbitral agreement in writing was established between the Plaintiff and the Defendant. Lastly, one must determine whether the instant case satisfies the requirements requisite for the Korean court to recognize and enforce foreign judgments.

2. As for the ground of appeal

A. Determination on the representation of Nonparty 1 (the ground of appeal No. 2)

Whether the Defendant, principal of the instant case, assumes a duty for a third party resulting from the act of Nonparty 1, an employee hired by the Defendant, must be governed by the law of the Republic of Korea, where the main business office and the representative *locus actus* of the Defendant is located (Article 18(2) of the Act on Private International Law).

Taking into account the circumstances presented in the lower judgment, the lower court determined that: (a) Nonparty 1 had the representation authority to sign on the instant contract or an arbitral contract on behalf of the Defendant, or, at least, there are justifiable grounds to believe so; and (b) the instant contract including the provision on arbitral agreement is deemed to have established apparent representation, and thus, is binding on both the Plaintiff and Defendant.

Examining the reasoning of the lower judgment in light of the relevant legal principles and the record, the lower court did not err by misapprehending the legal principle regarding "apparent representation in excess of authority," prescribed in Article 126 of the Civil Act, as alleged by the ground of appeal.

B. Determination on the governing law regarding the establishment of arbitral agreement (the ground of appeal No. 1)

<u>According to the latter part of Article 5(1)(a) of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (hereinafter "New York Convention"), one of the grounds for refusing recognition and enforcement of arbitral awards is when the pertinent arbitral agreement is invalid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made. According to the provision *supra*, the governing law for determining the establishment of an arbitral agreement and its validity would primarily be the law to which the parties have subjected the said agreement, and where there exists no indication thereon, the law of the country where the award was made</u> (*see, e.g.*, Supreme Court Decision 2012Da84004, Mar. 24, 2016).

As will be examined *infra*, (a) Article 12 of the standard terms and conditions in the instant case, which have been incorporated into the elements of the instant contract, stipulated that California law would be the governing law of the instant contract; and (b) Article 13 stipulates that all disputes arising from the instant case shall be conclusively settled by arbitration in Los Molinos, California, U.S., pursuant to the arbitral rules set by the International Chamber of Commerce. As such, it appears that the Plaintiff and the Defendant selected California law as the governing law of the arbitral agreement.

Based on the legal principle *supra*, the lower judgment, which states to the effect that the governing law of the arbitral agreement in the instant case is California law, is therefore justifiable. The lower court did not err by misapprehending the legal principle on the selection of the implied governing law of an arbitral agreement.

C. Determination on the existence of arbitral agreement in writing (the ground of appeal No. 3)

(1) According to the reasoning of the lower judgment and the record, following facts are revealed.

(A) On March 19, 2010, the Plaintiff sent an email to Nonparty 1, to which the instant proposal was attached, including the quantity of walnuts that can be supplied and the confirmed price thereof. In the instant proposal, an English sentence was written, which read: "transaction is subject to the standard terms and conditions under the Defendant Company's documents confirming the purchase and sale contract (hereinafter "instant expression").

(B) On March 26, 2010, Nonparty 1 received an order from Nonparty 2, who is the Defendant's senior vice president, to negotiate the instant contract, with the same condition as in the first spot transaction made in February 2010. On the same day, Nonparty 1 sent to the Plaintiff an email, confirming the Plaintiff's will to purchase the quantity specified in the instant proposal, which was presented by the Plaintiff to the Defendant, with the copy of the instant proposal attached.

(C) On April 6, 2010, the Plaintiff sent the copy of the documents confirming the purchase and sale contract to Nonparty 1. At the bottom of the copy was a sentence written in English that read: "A purchaser is deemed to have accepted the standard terms and conditions stated in the back of this contract, if the purchaser does not sign and return this contract within 7 days, and/or, upon receiving walnuts."

(D) Nonparty 1 delivered the copy of the documents confirming the purchase and sale contract to Nonparty 2. The Defendant neither returned the documents confirming the purchase and sale contract nor raised objections within the period fixed in the documents *supra*.

(E) On August 27, 2010, Nonparty 1 decided to purchase walnuts from different suppliers, and expressed its will of not wanting to be supplied with walnuts pursuant to the instant proposal and the documents confirming the purchase and sale contract.

(F) On February 2010, prior to the instant contract, the initial spot transaction was made between the Plaintiff and the Defendant, and the instant sentence was inserted. In other words, on February 5, 2010, the Plaintiff sent an email to Nonparty 1, attached the documents under the heading of (i) the Plaintiff's proposal of yearly volume; and (ii) price of the shipped amount for the first three months. The latter document contained the instant expression. The transaction was completed smoothly, with the Plaintiff supplying walnuts to the Defendant and the Defendant making full payments therefor.

(2)The lower court determined that there existed arbitral agreement in writing for the following reasons.

(A) The instant contract entered into force by: (a) the Plaintiff making a promise by means of sending the proposal to the Defendant; and (b) the

Defendant accepting the instant proposal by means of sending an email that confirms its intent to purchase, with the copy of the proposal attached.

(B) According to the law of California, the standard terms and conditions in the instant contract are included in the content of the contract, considering that instant proposal expressly stated that the standard terms and conditions in the instant contract apply to a contract, and that the Defendant accepted the proposal without any conditions, where it could easily be provided with the standard terms and conditions from the Plaintiff. Even if this is not the case, the Defendant neither returned nor raised objections regarding the standard terms and conditions attached to the documents confirming the purchase and sale contract in the instant case within the fixed period, thereby incorporating the standard terms and conditions in the instant case into the content of the instant contract.

(C) The arbitral clause of the standard terms and conditions in the instant case is "an arbitral clause in a contract" pursuant to Article 2(2) of the New York Convention, constituting an agreement in writing under which "the parties undertake to submit to arbitration all or any differences which have arisen between them," as stated in Article 2(1) of the Convention.

(3) Examining the procedural matters, including the structure and content of the initial spot transaction, which predated the instant contract, and the reasoning of the lower judgment in light of the relevant legal principles, the lower judgment was not erroneously made by misapprehending the legal principle on arbitral agreement in writing as alleged by the ground of appeal.

D. Determination on the meaning of excluding double exequatur and fulfillment of the requirements for recognition of foreign judgments (the ground of appeal No. 4)

(1) The meaning of excluding double exequatur pursuant to the New York Convention

(A) <u>The New York Convention removed the need for double enforcement decision or double exequatur by stipulating that an arbitral award has to become binding on the parties (Article 5(1)(e)), instead of requiring proof of finality of the award. It means that the party applying for recognition and enforcement of foreign arbitral awards may obtain a decision of enforcement in a country where the said party seeks the enforcement, instead of applying for separate procedures, such as enforcement decision or declaration of enforceability. The purport of this pertinent provision may not be construed as having prohibited filing of claims for enforcement decision in the enforcement country on the ground that the country where the arbitrary award was given rendered an affirmative decision</u>.

(B) According to the reasoning of the lower judgment, partly cited by the lower court, and the record, following facts are revealed.

The Plaintiff filed for arbitration against the Defendant at the International Court of Arbitration for the payment of (i) compensation for damages; (ii) interest incurred prior to the arbitral judgment was made (hereinafter "prejudgment interest"); and (iii) cost for attorney's fees and arbitration. On March 18, 2014, the International Court of Arbitration rendered an arbitration judgment (hereinafter "instant judgment"). The instant judgment adjudicated that the Defendant owe the Plaintiff (i) USD 726,023.50 for compensation for damages; (ii) USD 258,384.09 for prejudgment interest; (iii) USD 332,507.19 for the expenses spent by the Plaintiff with regard to the arbitral procedure; (iv) USD 332,507.19 for the cost of attorney's fees; and (v) USD 75,000 for the cost of arbitral judgment.

The Defendant filed a lawsuit over the force of the arbitral clause in the standard terms and conditions in the instant case at the United States District Court for the Eastern District of California (hereinafter "instant U.S. court"). The Plaintiff made a claim for (a) the recognition of the instant arbitral judgment; (b) payment of the cost for attorney's fee spent in the litigation procedure at the instant U.S. court; and (c) payment of prejudgment interest for the period from the date of arbitral judgment to the date of the instant U.S. court's decision.

On January 23, 2015, the instant U.S. court: (a) invoked the application for recognition of the instant arbitral judgment; (b) determined that the Plaintiff had the right to interest payments which incurred prior to the adjudication at a rate of 10 percent (payment ①); and the right to partial payment of the cost of attorney's fees amounting to USD 148,058.50 (payment ②) (hereinafter "instant U.S. court decision"). This decision was finalized.

The Plaintiff filed a lawsuit for (a) compulsory execution of the arbitral award in the instant case; and (b) authorization of compulsory execution of the parts of the instant U.S. court decision ordering the payment of ① and ② in the preceding paragraph.

(C) Examining such factual relation in light of the legal principle *supra*, the Plaintiff is not precluded from seeking an enforcement decision on the instant arbitral award in the Republic of Korea, which is an enforcing country, based on the mere fact that it received a recognition decision from a court in the U.S., the country where an arbitral judgment is rendered. Furthermore, insofar as the Plaintiff is seeking an enforcement decision only with regard to the part ordering monetary payment, which is the remaining part of the instant U.S. court decision after excluding the part on recognition of the instant arbitral judgment, the issue of double exequatur cannot be brought up on the remaining part *supra*. The ground of appeal concerning this part is therefore disavowed.

(2) Requirements for recognition of foreign judgments

By comprehensively taking into account the circumstances presented, the lower court held that the instant U.S. court decision satisfied all the requirements stipulated under each subparagraph of Article 217(1) of the Civil

Procedure Act.

Examining the reasoning of the lower judgment in light of the relevant legal principles and the record, there is no error in the lower judgment resulting from the misapprehension of the legal principle on international jurisdiction and recognition of foreign judgments.

3. Conclusion

The appeal is dismissed and the cost of appeal is assessed against the losing party. It is so decided as per Disposition by the assent of all participating Justices on the bench.

Justices Jo Hee-de (Presiding Justice)
Kim Chang-suk
Kim Jae-hyung
Min You-sook (Justice in charge)

Supreme Court Decision 2015Du2994 Decided August 1, 2018【Revocation of Disposition Imposing Penalty Surcharge】

【Main Issues and Holdings】

[1] Meaning of "material fact" under Article 429(1)1 of the former Financial Investment Services and Capital Markets Act

[2] In a case where "major shareholder" is indicated as a nominal shareholder in a securities registration statement albeit the person owning the relevant shares in one's account and the nominal shareholder are different, whether it constitutes "making a false description regarding a material fact in a securities registration statement" as prescribed by Article 429(1)1 of the former Financial Investment Services and Capital Markets Act (affirmative)

Whether this legal doctrine is likewise applicable in cases where an issuer that submits a securities registration statement for the purpose of subscription or sale of securities is a foreign entity established according to the relevant foreign law (affirmative in principle)

【Summary of Decision】

[1] In the event a purchaser of securities, etc. commits a violation by intention or gross negligence, that is, makes a false description or representation concerning a material fact in the securities registration statement (including the statement of correction and required documents) or omits to describe or represent any material fact therein, a penalty surcharge not exceeding 3% (or KRW 2 billion if the amount exceeds KRW 2 billion) of the amount of subscription price or sale price indicated on the relevant registration statement is imposable (Articles 429(1)1 and 430(1) of the former Financial Investment Services and Capital Markets Act (amended by Act No. 11845, May 28, 2013)). Here, the term "material fact" means "matters that can have a considerable impact on an investor's rational decision-making or a financial investment product value."

[2] According to Article 8-1-1 of the Standard Form for Disclosure established by the governor of the Financial Supervisory Service (FSS) by sequential delegation from Article 119(6) of the former Financial Investment Services and Capital Markets Act (amended by Act No. 11845, May 28, 2013; hereinafter "Capital Markets Act"), Article 125(3) of the former Enforcement Decree thereof (amended by Presidential Decree No. 22197, Jun. 11, 2010), and Article 2-6(9) of the former Regulations for Issuance and Disclosure of Securities (amended by Financial Services Commission Notice No. 2009-41, Jul. 6, 2009), the name of a major shareholder and the number of shares by type

each owned by the major shareholder ought to be indicated on the securities registration statement. Article 1-1-2 Subparag. 7 of the Standard Form for Disclosure defines a "major shareholder" as a major shareholder prescribed by Article 9(1)1 of the Capital Markets Act, that is, "a person who owns the largest number of shares after combining the shares (including deposit receipts related to the shares) of that person and related persons of the same person stipulated by the Presidential Decree held in either party's account based on the total number of outstanding voting shares issued by an entity." Accordingly, if a person acquired shares at one's expense and gains/losses therefrom are attributed to that person, the relevant securities registration statement ought to indicate said person as the major shareholder even if shares were purchased under a third party's name and not one's name.

Matters related to a major shareholder falls under a "material fact" that is considerably relevant to making rational investment decisions. Therefore, despite a person owning shares in one's account and a nominal shareholder are different, if the nominal shareholder is indicated as a "major shareholder" on a securities registration statement, this constitutes "making a false description as to a material fact in a securities registration statement" as prescribed by Article 429(1)1 of the Capital Markets Act.

This legal doctrine holds true in cases where an issuer that submits a securities registration statement for the purpose of securities subscription or sale is a foreign entity established according to the relevant foreign law, so long as a statement written based on the disclosure form of the International Organization of Securities Commission (IOSCO) is not submitted.

【Reference Provisions】 [1] Articles 429(1)1 and 430(1) of the former Financial Investment Services and Capital Markets Act (Amended by Act No. 11845, May 28, 2013) / [2] Articles 119(6) and 429(1)1 of the former Financial Investment Services and Capital Markets Act (Amended by Act No. 11845, May 28, 2013); Article 125(3) of the former Enforcement Decree of the Financial Investment Services and Capital Markets Act (Amended by Presidential Decree No. 22197, Jun. 11, 2010)

Article 119 of the former Financial Investment Services and Capital Markets Act (Registration of Public Offering or Sale)

(6) Notwithstanding paragraphs (1) through (5), no registration statement need [to] be submitted if the conditions prescribed by Presidential Decree are met, such as where enough disclosures are being made on the issuer and securities of the same type. *<Newly inserted by Act No. 11845, May 28, 2013>*

Article 429 of the former Financial Investment Services and Capital Markets Act (Penalty Surcharges on Violation in Public Disclosure)

(1) The Financial Services Commission impose on a person referred to in each subparagraph of Article 125(1) a penalty surcharge not exceeding three percent of the amount of public offering or sale written on the relevant

registration statement (or two billion won if the amount exceeds two billion won), if: *<Amended by Act No. 8863, Feb. 29, 2008>*

1. The person makes a false description or representation concerning a material fact in the statement, prospectus, or any other document submitted as set forth in Article 119, 122, or 123 or omits to describe or represent any material fact therein[.]

Article 430 of the former Financial Investment Services and Capital Markets Act (Imposition of Penalty Surcharges)

(1) The penalty surcharge under Articles 428 and 429 (excluding paragraph (4)) shall be imposed only where a person subject to the imposition of a penalty surcharge commits a violation under the relevant provision by intention or gross negligence. *<Amended by Act No. 11845, May 28, 2013>*

Article 125 of the former Enforcement Decree of the Financial Investment Services and Capital Markets Act (Matters to be Contained in Registration Statements and Accompanying Documents)

(3) A corporation that has a subsidiary as prescribed in Article 1-3(1) of the Enforcement Decree of the Act on External Audit of Stock Companies (hereinafter referred to as "corporation obligated to prepare consolidated financial statements"), among corporations required to submit a registration statement under paragraph (1), shall state in its registration statement matters concerning financial standing referred to in paragraph (1)3(c) and other matters prescribed and publicly notified by the Financial Services Commission based on its consolidated financial statements prescribed in subparagraph 2 of Article 1-2 of the Act on External Audit of Stock Companies (hereinafter referred to as "consolidated financial statements") including its financial statements; and shall state the audit opinion on its consolidated financial statements and financial statements as the auditor's opinion referred to in paragraph (1)3(d). *<Newly inserted by Presidential Decree No. 22197, Jun. 11, 2010>*

【Reference Case】 [1] Supreme Court Decision 2014Du36259 decided Feb. 18, 2016

【Plaintiff-Appellant】 KB Securities Co., Ltd. (formerly Hyundai Securities Co., Ltd.) (Shin & Kim, Attorneys Kim Yong-dam et al., Counsel for the plaintiff-appellant)

【Defendant-Appellee】 Securities and Futures Commission (SFC)

【Judgment of the court below】 Seoul High Court Decision 2015Nu82 decided June 16, 2015

【Disposition】 The final appeal is dismissed. The cost of the final appeal is assessed against the Plaintiff.

【Reasoning】 The grounds of appeal are examined.

1. Regarding ground of appeal No. 1

A. In the event a purchaser of securities, etc. commits a violation by intention or gross negligence, that is, makes a false description or representation concerning a material fact in the securities registration statement (including the statement of correction and required documents) or omits to describe or represent any material fact therein, a penalty surcharge not exceeding 3% (or KRW 2 billion if the amount exceeds KRW 2 billion) of the amount of subscription price or sale price indicated on the relevant registration statement is imposable (Articles 429(1)1 and 430(1) of the former Financial Investment Services and Capital Markets Act (amended by Act No. 11845, May 28, 2013)). Here, the term "material fact" means "matters that can have a considerable impact on an investor's rational decision-making or a financial investment product value" (*see, e.g.*, Supreme Court Decision 2014Du36259, Feb. 18, 2016).

According to Article 8-1-1 of the Standard Form for Disclosure established by the governor of the Financial Supervisory Service (FSS) by sequential delegation from Article 119(6) of the former Financial Investment Services and Capital Markets Act (amended by Act No. 11845, May 28, 2013; hereinafter "Capital Markets Act"), Article 125(3) of the former Enforcement Decree thereof (amended by Presidential Decree No. 22197, Jun. 11, 2010), and Article 2-6(9) of the former Regulations for Issuance and Disclosure of Securities (amended by Financial Services Commission Notice No. 2009-41, Jul. 6, 2009), the name of a major shareholder and the number of shares by type each owned by the major shareholder ought to be indicated on the securities registration statement. Article 1-1-2 Subparag. 7 of the Standard Form for Disclosure defines a "major shareholder" as a major shareholder prescribed by Article 9(1)1 of the Capital Markets Act, that is, "a person who owns the largest number of shares after combining the shares (including deposit receipts related to the shares) of that person and related persons of the same person stipulated by the Presidential Decree held in either party's account based on the total number of outstanding voting shares issued by an entity." Accordingly, if a person acquired shares at one's expense and gains/losses therefrom are attributed to that person, the relevant securities registration statement ought to indicate said person as the major shareholder even if shares were purchased under a third party's name and not one's name.

Matters related to a major shareholder falls under a "material fact" that is considerably relevant to making rational investment decisions. Therefore, despite a person owning shares in one's account and a nominal shareholder are different, if the nominal shareholder is indicated as a "major shareholder" on a securities registration statement, this constitutes "making a false description as to a material fact in a securities registration statement" as prescribed by Article 429(1)1 of the Capital Markets Act.

This legal doctrine holds true in cases where an issuer that submits a securities registration statement for the purpose of securities subscription or sale is a foreign entity established according to the relevant foreign law, so long as a statement written based on the disclosure form of the International Organization of Securities Commission (IOSCO) is not submitted.

B. The reasoning of the lower judgment and the evidence duly admitted reveal the following facts.

(1) Around September 2007, China Oceans Resources Co., Ltd. (hereinafter "COR"), a foreign entity established according to Hong Kong law, concluded with the Plaintiff a leading underwriter agreement for the purpose of stock listing on the securities market operated by the Korea Exchange (hereinafter "KRX"). Accordingly, the Plaintiff became the purchaser of securities that are to be issued by COR in the Republic of Korea.

(2) On July 30, 2008, COR applied for a preliminary review for listing with the KRX and subsequently received a notice from the KRX that it "passed" the preliminary review. On May 22, 2009, COR underwent stock listing on the Korean stock market.

(3) On April 14, 2009, COR submitted a securities registration statement (hereinafter "instant instatement") with the Financial Services Commission (FSC) pursuant to Article 119(1) of the Capital Markets Act. The instant statement was not prepared based on the format of the Financial Supervisory Service (FSS) that was established in line with the standard disclosure format of the International Organization of Securities Commission (IOSCO). On the instant statement, "Nonparty 1" is indicated as COR's major shareholder and is also indicated as the same on the "Purchaser's Opinion" section (written by the Plaintiff) of the relevant securities registration statement.

(4) On April 13, 2012, the Defendant imposed a penalty surcharge of KRW 319,900,000 against the Plaintiff on the grounds that COR's major shareholder was falsely indicated as "Nonparty 1" on the instant statement, when in fact the major shareholder was "Nonparty 2."

(5) The relationship among the three parties (Nonparty 1, Nonparty 2, and COR) is explicated below.

(A) Nonparty 2 (a Chinese national) is the beneficial single-shareholder/representative director of Fujian Lianjiang Far-Sea Fishery Co., Ltd. (hereinafter "Lianjiang Fishery").

(B) On August 27, 2007, Nonparty 2 established COR in Hong Kong. At the time, Nonparty 2 fully paid the shareholders' equity and thereafter, fully paid the amount for subscription of new shares upon rights offering. Nonparty 1 (a Singapore national) is the registered shareholder on the corporate register of the Hong Kong-based company.

(C) Around that time, Nonparty 2 transferred the entire shares of Lianjiang Fishery to COR, thereby making COR the single-shareholder.

(D) On August 20, 2007, Nonparty 1 and Nonparty 2 concluded an options contract related to Nonparty 1's transfer of COR's entire shares to Nonparty 2 (HKD 1 per share) at the time chosen by Nonparty 2, but then rescinded the contract on July 24, 2008, which was right before the application for a preliminary review for listing.

(E) On August 18, 2009, following COR's listing of securities on the Korean stock market, Nonparty 1 and Nonparty 2 entered into a trust agreement that mainly pertains to the following: (i) Nonparty 1 shall be entrusted with holding COR's shares that Nonparty 2 owns; (ii) Nonparty 1 shall, upon Nonparty's request, handle the transfer of shares and the payment of dividends/gains incurred therefrom; and (iii) Nonparty 1 shall not exercise voting rights without Nonparty's instruction.

C. We examine such factual background in light of the legal principle as seen earlier.

Although COR is a foreign entity established according to Hong Kong law, it is required to submit a securities registration statement to the FSC for the purpose of share subscription in Korea. However, inasmuch as COR did not use the format that the FSS established in line with the IOSCO's standard disclosure format, it is required to indicate the major shareholder on the relevant securities registration statement according to Article 9(1)1 of the Capital Markets Act. At the time of COR's establishment and rights offering, Nonparty 2 acquired the company's shares under the name of Nonparty 1. Given that Nonparty 2 purchased the shares at one's expense, gains and losses incurred therefrom are also attributed to Nonparty 2. Thus, Nonparty 2 ought to be indicated on the instant statement as the major shareholder of COR pursuant to Article 9(1)1 of the Capital Markets Act. Nevertheless, Nonparty 1, who is the nominal shareholder, is indicated as the major shareholder under the "Purchaser's Opinion" section on the instant statement, thereby constituting "making a false description as to a material fact on a securities registration statement" as prescribed by Article 429(1)1 of the Capital Markets Act.

The lower judgment to the same effect is justifiable. In so determining, the lower court, as otherwise alleged in the ground of appeal, did not err by misapprehending the legal doctrines on the standard for determining the major shareholder of a foreign entity established according to the relevant foreign law or indicating the major shareholder on a securities registration statement, or by exceeding the bounds of the principle of free evaluation of evidence in contradiction with empirical and logical rules.

2. Regarding ground of appeal No. 2

After finding the facts as delineated in its holding in full view of the duly admitted evidence, the lower court determined that the Plaintiff (purchaser of shares) was unaware that information regarding the major shareholder, which is a material fact on the securities registration statement, was falsely indicated or that such false description was committed by gross negligence.

Examining the relevant legal principle and the record, the above determination of the lower court is justifiable. In so doing, contrary to what is alleged in the ground of appeal, the lower court did not err by misapprehending the legal doctrine on intentional or gross negligence related to false description of a major shareholder, or by exceeding the bounds of the principle of free evaluation contravening empirical and logical rules.

3. Conclusion

Therefore, the final appeal is dismissed, and the cost of the final appeal is assessed against the losing party. It is so decided as per Disposition by the assent of all participating Justices on the bench.

Justices Park Jung-hwa (Presiding Justice)
Park Sang-ok
Lee Ki-taik (Justice in charge)

Supreme Court Decision 2018Do9385 Decided August 30, 2018【Violation of the Act on the Aggravated Punishment, etc. of Specific Economic Crimes (Breach of Trust) (Partly Acknowledged Name of Crime: Occupational Breach of Trust)】

【Main Issue and Holding】

In the case where an indictment is motivated for a crime in which punishment is not heavier than the maximum statutory penalty and the factual basis is identical to an extraditable offense, whether such indictment is lawful based on the interpretation of the European Convention on Extradition and the Extradition Treaty between the Government of the Republic of Korea and the Government of the Republic of France (affirmative)

【Summary of Decision】

Article 14 Subparag. 3 of the European Convention on Extradition (hereinafter "Convention") provides that "When the description of the offence charged is altered in the course of proceedings, the extradited person shall only be proceeded against or sentenced insofar as the offence under its new description is shown by its constituent elements to be an offense which would allow extradition." This provision stipulates only the principle of specificity in cases where the name of a crime is changed following an indictment and does not include a provision on the change of a criminal fact prior to an indictment. Article 28 Subparag. 1 of the Convention provides, "This Convention shall, in respect of those countries to which it applies, supersede the provisions of any bilateral treaties, conventions or agreements governing extradition between any two Contracting Parties," whereas Subparag. 2 thereof provides, "The Contracting Parties may conclude between themselves bilateral or multilateral agreements only in order to supplement the provisions of this Convention or to facilitate the application of the principles contained therein." It can be inferred that agreements between contracting parties are applicable as a supplementary measure.

However, Article 15 Subparag. 3 of the Extradition Treaty between the Government of the Republic of Korea and the Government of the Republic of France (hereinafter "Treaty") stipulates that sentencing may be rendered for an indicted crime in cases where the factual basis is the same as that indicated on the extradition request and supplementary documents (Item (a)) and punishment that is either equal to or more lenient than the maximum punishment for an extraditable offense (Item (b)) is possible.

In view of the structure and contents of the Convention and Treaty, a motivated indictment ought to be deemed lawful where the factual basis of the crime in question is identical to an extraditable offense and the sentencing is not heavier than the maximum statutory penalty.

【Reference Provisions】 Articles 254 and 298 of the Criminal Procedure Act; Article 14 Subparag. 3 and Article 28 Subparags. 1-2 of the European Convention on Extradition; Article 15 Subparag. 3(a) and (b) of the Extradition Treaty between the Government of the Republic of Korea and the Government of the Republic of France

Article 254 of the Criminal Procedure Act (Methods of Instituting Public Prosecution and Bill of Indictment)

(1) The institution of public prosecution shall be made by filing a bill of indictment with a competent court.

(2) Copies, equal to the number of criminal defendants shall be annexed to the bill of indictment.

(3) The bill of indictment shall contain the following matters:

1. The names of the criminal defendants and other matters by which the criminal defendants can be identified;

2. The name of the crime;

3. The facts charged;

4. The applicable provisions of Acts.

(4) The facts charged shall be stated clearly by specifying the time and date, place, and method of a crime.

(5) Several separate charges or several applicable provisions of Acts may be stated in preliminarily or alternatively.

Article 298 of the Criminal Procedure Act (Amendments to Bill of Indictment)

(1) With permission of the competent court, the prosecutor may add, delete, or change the facts charged or applicable provisions of Acts stated in the bill of indictment. In this case, the court shall grant permission only when the identity of the facts charged is not disturbed.

(2) Where the court deems it reasonable in view of trial process, it shall request for the addition or change of the facts charged or applicable provisions of Acts.

(3) When there are additions, withdrawal, or changes of the facts charged or applicable provisions of Acts, the court shall promptly notify the causes thereof to the criminal defendant or his/her defense counsel.

(4) Where the court deems that the addition, withdrawal, or change of the facts charged or applicable provisions of Acts in the bill of indictment under the preceding three paragraphs may increase disadvantages of the criminal defendant, the court may, *ex officio* or upon request of the criminal defendant

or defense counsel, grant a recess of the trial for a period necessary for the criminal defendant to prepare his/her defense, by its ruling.

[This Article wholly amended by Act No. 2750, Jan. 25, 1973]

Article 14 of the European Convention on Extradition (Rule of Specialty)

3. When the description of the offence charged is altered in the course of proceedings, the extradited person shall only be proceeded against or sentenced insofar as the offence under its new description is shown by its constituent elements to be an offence which would allow extradition.

Article 28 of the European Convention on Extradition (Relations between this Convention and Bilateral Agreements)

1. This Convention shall, in respect of those countries to which it applies, supersede the provisions of any bilateral treaties, conventions or agreements governing extradition between any two Contracting Parties.

2. The Contracting Parties may conclude between themselves bilateral or multilateral agreements only in order to supplement the provisions of this Convention or to facilitate the application of the principles contained therein.

【Defendant】 Defendant

【Appellant】 Defendant and Prosecutor

【Defense Counsel】 Lee & Ko (Attorneys Lee In-hyeong et al.)

【Judgment of the court below】 Seoul High Court Decision 2017No3681 decided May 31, 2018

【Disposition】 All appeals are dismissed.

【Reasoning】 The grounds of appeal are examined (to the extent of supplement in case of supplemental appellate briefs not timely filed).

1. Regarding the Defendant's grounds of appeal

A. Determination as to the assertion that the indictment is unlawful

(1) <u>Article 14 Subparag. 3 of the European Convention on Extradition (hereinafter "Convention") provides that "When the description of the offence charged is altered in the course of proceedings, the extradited person shall only be proceeded against or sentenced insofar as the offence under its new description is shown by its constituent elements to be an offense which would allow extradition." This provision stipulates only the principle of specificity in cases where the name of a crime is changed following an indictment and does not include a provision on the change of a criminal fact prior to an indictment. Article 28 Subparag. 1 of the Convention provides, "This Convention shall, in respect of those countries to which it applies, supersede the provisions of any bilateral treaties, conventions or agreements governing extradition between any two Contracting Parties," whereas Subparag. 2 thereof provides, "The Contracting Parties may conclude between themselves bilateral or multilateral agreements only in order to supplement the provisions of this Convention or to</u>

facilitate the application of the principles contained therein." It can be inferred that agreements between contracting parties are applicable as a supplementary measure.

(2) However, Article 15 Subparag. 3 of the Extradition Treaty between the Government of the Republic of Korea and the Government of the Republic of France (hereinafter "Treaty") stipulates that sentencing may be rendered for an indicted crime in cases where the factual basis is the same as that indicated on the extradition request and supplementary documents (Item (a)) and punishment that is either equal to or more lenient than the maximum punishment for an extraditable offense (Item (b)) is possible.

(3) In view of the structure and contents of the Convention and Treaty, a motivated indictment ought to be deemed lawful where the factual basis of the crime in question is identical to an extraditable offense and the sentencing is not heavier than the maximum statutory penalty.

(4) The lower court determined that the instant motivated indictment was lawful on the grounds that the factual basis is identical regarding the Defendant's violation of the Act on the Aggravated Punishment, etc. of Specific Economic Crimes (hereinafter "Specific Economic Crimes Act"), which is an extraditable offense, and the violation of the Specific Economic Crimes Act (breach of trust), which is the indicted offense in this case. Examining the reasoning of the lower judgment in light of the aforementioned legal principle and the record, the lower court did not err by misapprehending the legal doctrine on the lawfulness of motivating an indictment due to misconstruing the Convention and Treaty.

B. Determination as to the assertion on admissibility and probative value

Based on its stated reasoning, the lower court (i) found admissible the fourth interrogatory of Nonindicted 1 prepared by the Prosecutor and the affidavit of Nonindicted 2 and Nonindicted 3 prepared by the Prosecutor as it satisfied the requirements under Article 314 of the Criminal Procedure Act, and (ii) determined that Nonindicted 4's partial testimony given during the first instance trial lacked credibility. Reviewing the reasoning of the lower judgment in light of the relevant legal principle and the record, the lower court did not err by misapprehending the legal doctrine as to the determination of probative value and admissibility of testimony in court as prescribed by Article 314 of the Criminal Procedure Act.

C. Determination as to the assertion on the merit

On the grounds indicated in its reasoning, the lower court upheld as is the first instance judgment convicting Nonindicted 5 Stock Company of committing occupational breach of trust and Nonindicted 6 Stock Company of violating the Specific Economic Crimes Act (breach of trust) (excluding the rationale-based acquittal portion). Examining the reasoning of the lower judgment in light of the relevant legal principle and duly admitted evidence, the lower court did not err by exceeding the bounds of the principle of the free evaluation of evidence contradicting empirical and logical rules, or by misapprehending the legal doctrines related to the establishment of breach of trust, joint principal offense, pecuniary damages, and unpunishable act after the crime.

D. Determination as to the assertion on the estimation of confiscation

The Defendant argues to the effect that the lower court's estimation of the confiscation amount is unlawful. However, the Defendant's claim does not constitute lawful grounds for appeal inasmuch as it was neither initially included in the Defendant's grounds of appeal nor regarded as the subject of *ex officio* determination of the lower court. Furthermore, in having upheld the first instance judgment regarding the estimated confiscation amount, the lower court did not err by misapprehending the legal doctrine as to the Act on Special Cases Concerning the Confiscation and Return of Property Acquired through Corrupt Practices and the estimation of confiscation.

2. Regarding the Prosecutor's grounds of appeal

The lower court, on the grounds stated in its reasoning, affirmed as is the first instance judgment acquitting Nonindicted 5 Stock Company of the charge of violating the Specific Economic Crimes Act (breach of trust) and, in relation to "○○○○○○○," acquitting Nonindicted 6 Stock Company of the charge of violating the Specific Economic Crimes Act (breach of trust) only in connection to the amount of KRW 170 million. Reviewing the reasoning of the lower judgment in light of the relevant legal principle and the record, the lower court did not err by exceeding the bounds of the principle of the free evaluation of evidence contravening empirical and logical rules, or by misapprehending the legal doctrine as to the intention of breach of trust and conviction.

Meanwhile, the Prosecutor appealed the entire portion of the lower judgment. However, neither the notice of appeal nor the appellate brief indicates any specific grounds of objection on the guilty portion.

3. Conclusion

Therefore, all appeals are dismissed. It is so decided as per Disposition by the assent of all participating Justices on the bench.

Justices Kwon Soon-il (Presiding Justice)
Lee Ki-taik
Park Jung-hwa (Justice in charge)
Kim Seon-soo

Supreme Court Decision 2018Da9920, 9937 Decided September 13, 2018【Unjust Enrichment, etc.; Agreed Amount, etc.】

【Main Issues and Holdings】

[1] Meaning of the principle of the equality of shareholders, and validity of an agreement by a company granting superior right or interest only to certain shareholders through breaching said principle (invalid in principle)

[2] In a case where: (a) Company A and its management and the Employee Stock Ownership Association (hereinafter "ESOA"), for the purpose of procuring operating capital, concluded with Party A a share purchase agreement detailing that "Party A shall purchase at par value partial shares owned by EOSA members issued by Company A and pay said purchase amount to Company A; extend a certain loan amount to Company A; and have the right to recommend one (1) executive officer of Company A"; (b) Company A and Party A subsequently entered into an agreement detailing that "Company A shall pay an agreed monthly amount to Party A and Party B (Party A's wife) in consideration for Party A's non-exercise of the foregoing right of executive officer recommendation," and said agreed amount was accordingly paid on a monthly basis to Party A et al.; and (c) Company A suspended payment and sought a claim for restitution of unjust enrichment by asserting that the aforesaid payment agreement was invalid as it contravened the principle of the equality of shareholders, the Court affirming that Company A's continuous payment of the agreed amount is deemed as granting Party A et al. a superior right that was not extended to Company A's other shareholders, thereby contradicting the principle of the equality of shareholders, grounded on the basis that Party A et al. lost status as Company A's creditor and only remained its shareholder upon having received payment in consideration from Company A for funding operating capital

【Summary of Decision】

[1] Under the principle of the equality of shareholders, a shareholder in a legal relationship with a company ought to receive equal treatment depending on the number of shares he or she owns. Barring exigent circumstances, an agreement by a company granting superior right or interest only to certain shareholders through breaching said principle is invalid.

[2] In a case where: (a) Company A and its management and the Employee Stock Ownership Association (hereinafter "ESOA"), for the purpose of procuring operating capital, concluded a share purchase agreement with Party A detailing that "Party A shall purchase at par value partial shares owned by

EOSA members issued by Company A and pay said purchase amount to Company A; extend a certain loan amount to Company A; and have the right to recommend one (1) executive officer of Company A"; (b) Company A and Party A subsequently entered into an agreement stipulating that "Company A shall pay an agreed monthly amount to Party A and Party B (Party A's wife) in consideration for Party A's non-exercise of the foregoing right of executive officer recommendation," and said agreed amount was accordingly paid on a monthly basis to Party A et al.; and (c) Company A suspended payment and sought a claim for restitution of unjust enrichment by asserting that the aforesaid payment agreement was invalid as it contravened the principle of the equality of shareholders, the Court held as follows: (a) inasmuch as the right of recommendation of executive officer was granted to Party A in consideration for Party A's provision of operating capital for share purchase and loan purposes to the financially-strapped Company A, the foregoing agreement relating to Company A's monthly payment of the agreed amount to Party A et al. in consideration for Party A's non-exercise of such right of recommendation may be deemed as a consideration for Party A's funding of operating capital; (b) that said, Party A et al.'s right to receive the agreed monthly amount is an extraordinary contractual right granted to a shareholder who is also a creditor, while Party A et al. obtained shareholder status of Company A starting from the period of payment of the share purchase amount and such shareholder right remains intact unless the shares are transferred; (c) thus, Party A et al. is deemed as having lost status as Company A's creditor but remaining as Company A's shareholder if having received payment in consideration from Company A for funding operating capital; and (d) yet, Company A's continuous payment of the agreed amount is deemed as granting Party A et al. a superior right that was not extended to Company A's other shareholders, thereby contradicting the principle of the equality of shareholders.

【Reference Provisions】 [1] Article 105 of the Civil Act; Articles 369(1), 464, and 538 of the Commercial Act / [2] Article 105 of the Civil Act; Articles 369(1), 464, and 538 of the Commercial Act

Article 105 of the Civil Act (Optional Provisions)

If the parties to a juristic act have declared an intention which differs from any provisions of statutes, which are not concerned with good morals or other social order, such intention shall prevail.

Article 369 of the Commercial Act (Voting Rights)

(1) Every shareholder shall have one vote for each share.

Article 464 of the Commercial Act (Standards for Distribution of Profits)

Distribution of profits shall be made in proportion to the number of shares held by each shareholder: *Provided*, That this shall not apply in cases falling under Article 344(1).

[This Article wholly amended by Act No. 10600, Apr. 14, 2011]

Article 538 of the Commercial Act (Distribution of Surplus Assets)

Surplus assets shall be distributed to shareholders in proportion to the number of shares held by each shareholder: *Provided*, That this shall not apply in cases falling under Article 344(1).

【Plaintiff-Counterclaim Defendant-Appellant】 Gwangnam Automobile Co., Ltd. (Attorney Choi Seung-jae, Counsel for the plaintiff-counterclaim defendant-appellant)

【Defendant-Counterclaim Plaintiff-Appellee】 Defendant 1 (Counterclaim Plaintiff) and one other (Attorney Lee Ssang-hee, Counsel for the defendant-counterclaim plaintiff-appellee)

【Judgment remanded】 Supreme Court Decision 2015Da68355, 68362 Decided January 12, 2017

【Judgment of the court below】 Daegu High Court Decision 2017Na71, 88 Decided December 13, 2017

【Disposition】 The part of the lower judgment against the Plaintiff-Counterclaim Defendant is reversed, and that part of the case is remanded to the Daegu High Court.

【Reasoning】 The grounds of appeal are examined (to the extent of supplement in case of supplemental appellate briefs not timely filed).

1. Ground of appeal No. 1

A. <u>Under the principle of the equality of shareholders, a shareholder in a legal relationship with a company ought to receive equal treatment depending on the number of shares he or she owns. Barring exigent circumstances, an agreement by a company granting superior right or interest only to certain shareholders through breaching said principle is invalid.</u>

B. The reasoning of the lower judgment and the duly admitted evidence reveals the following.

(1) Around 2005 when the business of Plaintiff-Counterclaim Defendant (hereinafter "Plaintiff") ran into financial trouble, the Plaintiff's management and the Employee Stock Ownership Association (EOSA) concluded a share purchase agreement with Defendant 1-Counterclaim Plaintiff (hereinafter "Defendant 1"). Key details of the share purchase agreement are as follows.

① Defendant 1 shall purchase 40,000 shares among the total shares held by members of the EOSA at par value (KRW 5,000 per share) and pay the purchase amount of KRW 200 million to the Plaintiff by July 14, 2005 (Parags. 1 and 2).

② Defendant 1 shall provide loans totaling KRW 400 million to the Plaintiff in four separate payments in equal amounts — KRW 100 million by July 28, 2005; KRW 100 million by September 14, 2005; KRW 100 million by October 14, 2005; and KRW 100 million by November 14, 2005 (Parag. 4).

③ Defendant 1 shall, upon providing the aforementioned loan to the Plaintiff, be granted the right to preferentially purchase the EOSA-owned shares (Parag. 3).

④ Defendant 1 shall have the right to recommend one (1) executive officer to the Plaintiff (hereinafter "recommendation right"), and the Plaintiff shall pay the recommended executive officer a salary equivalent to that of a full-time executive officer (Parag. 5).

(2) According to the share purchase agreement (hereinafter "the instant purchase agreement"), Defendant 1 paid KRW 200 million as the share purchase amount and acquired, under the name of the Defendants, 40,000 common shares owned by the EOSA members that had been issued by the Plaintiff. Thereafter, the Plaintiff borrowed and used said amount that was to be paid to the EOSA members. Defendant 1 loaned KRW 400 million to the Plaintiff pursuant to Parag. 4 of said agreement.

(3) Immediately following the conclusion of the share purchase agreement, the Plaintiff and Defendant 1 entered into an agreement detailing that the Plaintiff shall pay the Defendants KRW 2 million every month in consideration for Defendant 1 not exercising the recommendation right as mentioned above (hereinafter "the instant payment agreement"). Accordingly, the first monthly payment to the Defendants was made on July 31, 2005 and continued on until April 12, 2013 before monthly payments of KRW 2.5 million began to be made during the period from May 11 to July 11, 2013. Pursuant to the payment agreement, the Plaintiff paid the Defendants KRW 201.5 million in total prior to suspension of the same around August 2013. Of that amount, the Plaintiff paid KRW 70 million until around September 2008 upon having repaid the borrowed amount of KRW 400 million.

(4) The Plaintiff repaid Defendant 1 the borrowed amount, *supra*, until around September 2008, and subsequently paid either Defendant 1 or Defendant 2 as interest totaling KRW 87,670,547 from around July 2005 to around September 2008, i.e., equal payments of KRW 830,000 on 150 separate occasions over a 39-month period.

C. The lower court determined as *infra* based on the aforementioned factual basis.

The instant payment agreement, which pertains to the Defendants' provision of financial aid worth KRW 600 million to the cash-strapped Plaintiff, falls under either a loan consumption agreement or an agreement similar thereto relating to an individual transaction relationship, not a shareholder-employee relationship. Therefore, said agreement cannot be easily deemed as breaching the principle of the equality of shareholders.

D. However, the foregoing determination of the lower court is difficult to accept as is on the grounds delineated below.

(1) According to the payment agreement, the Plaintiff shall provide monthly payments of KRW 2 million to the Defendants in consideration for Defendant 1 not exercising the recommendation right as stipulated under the share purchase agreement. Inasmuch as such right was granted in consideration for Defendant 1's provision of KRW 600 million in operating capital (= share purchase amount of KRW 200 million + loan amount of KRW 400 million), the instant payment agreement under which the Defendants were to be paid KRW 2 million each month in consideration for non-exercise of the recommendation right may also be deemed as payment in consideration for Defendant 1's funding of operating capital (*see* Supreme Court Decision 2015Da68355 (principal claim), 268363 (principal claim) Decided January 12, 2017).

(2) That said, the Defendants' right to receive the monthly agreed amount is an extraordinary contractual right granted to a shareholder who is also a creditor, while the Defendants obtained shareholder status with respect to the Plaintiff starting from the period of purchasing 40,000 shares upon payment of the share purchase amount (KRW 200 million) and such shareholder status remains intact unless the aforementioned shares are transferred. Therefore, when the Plaintiff completed the payment in consideration to the Defendants for the provision of KRW 600 million in operating capital, deeming the Defendants to have lost status as the Plaintiff's creditor and only remaining as the Plaintiff's shareholder is sustainable. Yet, if the Plaintiff were to continuously pay the agreed amount, this would be granting the Defendants a superior right not extended to other shareholders of the Plaintiff, thereby contradicting the principle of the equality of shareholders.

(3) Furthermore, in full view of the relationship between the Plaintiff and the Defendants, not to mention the following circumstances revealed in the record, the point in time when the Defendants lose creditor status upon the Plaintiff's payment in consideration for the funding of operating capital totaling KRW 600 million is not when the loan principal and interest (KRW 400 million) is repaid but the period thereafter. While the matter should be determined based on the specific allegations and proof of the relevant parties, there is considerable reason to deem that the Plaintiff's payment in consideration does not exceed the amount equivalent to the financial aid provided by the Defendants.

① The contractual terms of the instant purchase agreement concluded between the Plaintiff and the Defendants are: (i) the Defendants shall purchase 40,000 shares of the Plaintiff and the purchase amount shall be set at KRW 200 million based on the par value; (ii) the Defendants shall loan the Plaintiff the amount of KRW 400 million in operating capital; and (iii) Defendant 1 shall be granted the right of recommendation of executive officer. Such contractual terms were uniformly agreed upon and thus cannot be separately treated. The same holds true for the instant payment agreement under which the Plaintiff agreed to provide monthly payments in consideration for Defendant 1's non-exercise of the recommendation right.

② The Plaintiff-issued shares that were to be purchased by the Defendants had been owned by the members of the EOSA, and the Plaintiff was planning to use most of the share purchase amount upon the conclusion of the instant purchase agreement. In fact, the Plaintiff borrowed KRW 200 million from the EOSA members and used it.

③ Factoring the Plaintiff's weak financial structure and vulnerable business condition at the time, deeming that the value of the 40,000 shares purchased by the Defendants to have been worth KRW 200 million (actual share purchase amount) is difficult; moreover, the share purchase amount was set based on the par value for convenience. In line with the instant purchase agreement (including the provision of loans totaling KRW 400 million), the Defendants, as a shareholder, appear to have anticipated that they will reap gains from the rise in share value in the future in consideration for funding operating capital to the financially-strapped Plaintiff.

④ Setting aside the loan principal and interest (KRW 400 million) the Plaintiff owed, the Plaintiff paid monthly agreed amounts to the Defendants based on the instant payment agreement that continued on after September 2008 when the Plaintiff fully performed the loan obligation. Thus far, the foregoing monthly payments by the Plaintiff amount to KRW 201.5 million, slightly exceeding the share purchase amount of KRW 200 million.

E. Yet, based on its stated reasoning, the lower court determined that the instant payment agreement did not contradict the principle of the equality of shareholders. In so doing, the lower court erred by misapprehending the legal doctrine on the principle of the equality of shareholders, which led to the failure to exhaust all necessary deliberations regarding the point in time when the Defendants lost creditor status, thereby adversely affecting the conclusion of the judgment. The allegation contained in the grounds of appeal on this point is with merit.

2. Ground of appeal No. 2

A. The reasoning of the lower judgment reveals the following.

The share purchase agreement in this case neither stipulates that an executive officer recommended by Defendant 1 may immediately be appointed as a director without a resolution of the general meeting of shareholders nor sets a specific salary to be paid to the executive officer so recommended. Thus, the instant payment agreement does not violate either Article 382(1) of the Commercial Act providing that directors shall be nominated by the general meeting of shareholders or Article 388 of the Commercial Act stipulating that the salary of directors may be determined by the general meeting of shareholders.

B. In so determining, the lower court, contrary to what is alleged in the grounds of appeal, did not err by misapprehending the legal doctrine on the formation of a stock company.

Furthermore, the Plaintiff asserts that the Defendants' intervention, as a creditor, in the appointment of directors is ineffective. However, inasmuch as the pertinent recommendation right centers on Defendant 1's right to recommend one (1) executive officer who is then appointed by the Plaintiff's management and the EOSA following the required procedures under the Commercial Act (i.e., resolution of the board of director and resolution of the general meeting of shareholders), readily concluding that such granting of right to Defendant 1 violates the Commercial Act's provision on the formation of a stock company is difficult. Also, as seen earlier, insofar as the Defendants entered into the instant payment agreement stipulating the receipt of monthly payments in consideration for non-exercise of the recommendation right as stipulated in the share purchase agreement, there is considerable ground to deem that the Defendants' recommendation right definitively extinguished. In that sense, the ground of appeal on this part is meritless.

3. Ground of appeal No. 3

The allegation contained in the grounds of appeal on this part is a new allegation only raised for the first time in the final appeal, and hence cannot be a legitimate ground of appeal in the lower trial.

4. Ground of appeal No. 4

A. Examining the reasoning of the lower judgment in light of the relevant legal doctrine and the record, the lower court, on the grounds indicated in its holding, deemed that the monthly payments pursuant to the instant payment agreement did not contravene Article 467-2 of the Commercial Act, and thus rejected the Plaintiff's claim seeking restitution of unjust enrichment. In so determining, as otherwise alleged in the grounds of appeal, the lower court did not err by exceeding the bounds of the principle of free evaluation of evidence contradicting empirical and logical rules, or by misapprehending the legal doctrines related to the interpretation of contractual terms and the prohibition of profit offering to shareholders.

B. Meanwhile, the Plaintiff asserts that the latter part regarding payment in consideration went against Article 467-2 of the Commercial Act on the basis that the instant payment agreement was concluded in consideration for not exercising the recommendation right as well as the shareholder right. However, this is a new allegation raised for the first time in the final appeal, and hence cannot be a legitimate ground of appeal. In addition, as seen earlier, the monthly payments based on the instant payment agreement was payment that the Plaintiff agreed to pay the Defendants in consideration for not exercising the recommendation right. The allegation in the grounds of appeal on this part is unsustainable.

5. Conclusion

Therefore, without further proceeding to decide on the remaining grounds of appeal, the part of the lower judgment against the Plaintiff is reversed, and that part of the case is remanded to the lower court for further proceedings consistent with this Opinion. It is so decided as per Disposition by the assent of all participating Justices on the bench.

Justices Cho Jae-youn (Presiding Justice)
Kim So-young (Justice in charge)
Noh Jeong-hee

Supreme Court Decision 2018Do8438 Decided October 12, 2018【Violation of the Financial Investment Services and Capital Markets Act; Violation of the Act on the Aggravated Punishment, Etc., of Specific Economic Crimes (Fraud)】

【Main Issues and Holdings】

Matters to be taken account of when calculating “the amount equivalent to the gain accrued from the violation” to apply Article 443(1) proviso and Article 443(2) of the former Financial Investment Services and Capital Markets Act and whether “the gain accrued from the violation” includes both realized gain and unrealized gain (affirmative)

In a case where the stock price is raised by market price manipulation, method of calculating the realized gain therefrom

【Summary of Decision】

The former Financial Investment Services and Capital Markets Act (amended by Act No. 11845, May 28, 2013) (hereinafter “Capital Markets Act”) prohibits market price manipulation (Article 176) and imposes criminal punishment on any person who violates pertinent provision (Article 443). The Capital Markets Act imposes aggravated punishment depending on the amount equivalent to “the gain accrued from or loss avoided by the violation,” which is defined as one of the constituting elements of crime (Article 443(1) proviso and Article 443(2)). As such, its application warrants caution to ensure (i) the legality principle, which ensures a reasonable balance between a crime and a punishment through strict and cautious calculation of the gains accrued from the violation, and (ii) the responsibility principle, which demands that a punishment must be based on and proportionate to the attendant responsibility.

“The gain accrued from the violation” refers to the whole of gains from the causal relationship generated by a manipulator’s violation, which encompasses both (a) the gains already accrued as a result of specific transactions during the period of market price manipulation (hereinafter “realized gain”) and (b) the assessed gain of the stocks or the securities from the preemptive right to new stocks, both of which subject to market price manipulation, in possession at the end of the pertinent market price manipulation (hereinafter “unrealized gain”).

In a case where a surge in stock price is caused by market price manipulation, the realized gain therefrom is calculated as follows: [(the difference between selling price per unit and buying price per unit) × (among the quantity of stocks bought and the quantity of stocks sold, those with smaller quantity ("matched quantity of stocks bought and sold"))] – (transaction cost at the time of the disposal of the stocks). Where stock acquisition was intended for acquiring gains from market price manipulation, the outcome of the weighted average of the actual purchase amount by the number of stocks bought would be the buying price per unit; where the disposed stocks were issued from the securities from the preemptive right to new stocks, the buying price per unit would be equivalent to the outcome of the weighted average of the sum of the strike price of the preemptive right to new stocks and the purchase amount of the securities from the preemptive right to new stocks (hereinafter "purchase price of the preemptive right to new stocks") by the number of stocks bought.

However, if the acquisition of the stocks or the securities from the preemptive right to new stocks was not intended for obtaining gains through market price manipulation, the stock's closing price on the day preceding the period of market price manipulation should be deemed as the buying price per unit. This is because the purchase price of the previously possessed stocks or the preemptive right to new stocks is irrelevant to market price manipulation.

After all, if the stock's closing price on the day preceding the period of market price manipulation (hereinafter "closing price before market price manipulation") is set at a higher price than the purchase price of the previously possessed stocks or the preemptive right to new stocks, due to either regular price fluctuations or fluctuations irrelevant to a manipulator, the gain equivalent to the difference between the closing price before market price manipulation and the purchase price of the previously possessed stocks or the preemptive right to new stocks is deemed to have been accrued irrespective of market price manipulation, and thus, cannot be deemed as "the gain accrued from the violation." On the other hand, where the stock's closing price on the day preceding the period of market price manipulation had been set at lower price than the purchase price of the stocks or the preemptive right to new stocks, and later increased to higher levels than the purchase price of the stocks or the preemptive right to new stocks because of market price manipulation, the gain equivalent to the difference between the purchase price of the stocks or the preemptive right to new stocks and the stock's closing price on the day preceding the period of market price manipulation is attributable to market price manipulation, and thus, constitutes "the gain accrued from the violation."

In the meantime, where stocks are sold during the period of market price manipulation, selling price per unit should be determined by computing the weighted average of the actual sell amount by the quantity of stocks sold.

【Reference Provisions】 Articles 176, 443(1) and (2) of the former Financial Investment Services and Capital Markets Act (amended by Act No. 11845, May 28, 2013)

Article 176 of the current Financial Investment Services and Capital Markets Act (Prohibition on Market Price Manipulation, Etc.)

(1) No one shall engage in any of the following acts with intent to mislead anyone into misapprehending that the trading of listed securities or exchange-traded derivatives is in bull market, or to mislead any third person into making a wrong judgment:

1. Selling securities or exchange-traded derivatives in collusion with third person to sell the securities or exchange-traded derivatives at the same price as his/her sale price, or at an agreed value at the same time he/she sells them;

2. Purchasing securities or exchange-traded derivatives in collusion with third person to sell the securities or exchange-traded derivatives at the same price as his/her purchase price, or at an agreed value at the same time he/she purchases them;

3. Appearing to trade securities or exchange-traded derivatives with no intent to transfer the interest or right therein;

4. Entrusting or being entrusted with any act set forth in subparagraphs 1 through 3.

(2) No one shall engage in any of the following acts with intent to attract anyone to trade listed securities or exchange-traded derivatives: *<Amended by Act No. 11845, May 28, 2013>*

1. Misleading any person into misapprehending that the trading of such securities or derivatives is in bull market, or selling or purchasing, or entrusting or being entrusted with the sale or purchase of, such securities or derivatives to cause a fluctuation in the market price (referring to the market price formed in the securities market or the derivatives market, or the market price formed in the course of intermediating the trading of listed stocks through an alternative trading system, or other market price prescribed by Presidential Decree; hereinafter the same shall apply);

2. Disseminating a rumor that a fluctuation in the market price for such securities or derivatives is being caused by his/her or a third person's market manipulation;

3. Making a false or misleading representation concerning a material fact in trading such securities or exchange-traded derivatives.

(3) No one shall engage in making purchases or sales in connection with listed securities or exchange-traded derivatives or shall entrust or be entrusted with such act, with intent to fix or stabilize the market price of the listed securities or exchange-traded derivatives: *Provided,* That the same shall not apply in any of the following cases:

1. Where an investment trader (limited to an investment trader who has entered into an underwriting contract with the issuer or owner of the securities subject to public offering or sale; hereafter the same shall apply in this Article) trades such securities with intent to make the public offering

or sale of the securities smooth by stabilizing the price of the securities (hereafter in this paragraph referred to as "manipulation for stabilization") during the period beginning on a day specified by Presidential Decree not exceeding 30 days before the end of the subscription period for the public offering or sale of the securities, and ending on the expiration of the subscription period;

2. Where an investment trader trades securities to create supply and demand (hereafter in this paragraph referred to as "market creation") for the securities publicly offered or sold in a manner prescribed by Presidential Decree during a period prescribed by Presidential Decree not exceeding six months from the day on which the securities are listed;

3. Where a person specified by Presidential Decree, such as an executive officer of the issuer of securities publicly offered or sold, entrusts an investment trader with manipulation for stabilization;

4. Where an investment trader is entrusted with manipulation for stabilization in accordance with subparagraph 3;

5. Where an underwriter of securities publicly offered or sold, entrusts an investment trader with marker creation;

6. Where an investment trader is entrusted to create market in accordance with subparagraph 5.

(4) Where any of securities, derivatives or underlying assets of the securities or derivatives are listed on an exchange, or in other equivalent circumstances prescribed by Presidential Decree, no one shall engage in any of the following acts in connection with the trade of such securities or derivatives or other transactions (hereafter in this paragraph and Articles 177 and 443 (1) 7 referred to as "trade, etc."): *<Amended by Act No. 9407, Feb. 3, 2009; Act No. 11845, May 28, 2013>*

1. Causing a fluctuation in, or fixing, the market price of underlying assets of certain derivatives with intent to earn or causing a third party to earn unjust profits from the trade, etc. of such derivatives;

2. Causing a fluctuation in, or fixing, the market price of derivatives with intent to earn, or causing a third party to earn, unjust profits from the trade, etc. of such underlying assets of derivatives;

3. Causing a fluctuation in, or fixing, the market price of securities linked to certain securities prescribed by Presidential Decree or underlying assets of such securities with intent to earn, or causing a third party to earn, unjust profits from the trade, etc. of such securities;

4. Causing a fluctuation in, or fixing, the market price of securities with intent to earn, or causing a third party to earn, unjust profits from the trade, etc. of underlying assets of such securities;

5. Causing a fluctuation in, or fixing, the market price of derivatives the underlying assets of which is the same as or similar to those of such derivatives with intent to earn, or causing a third party to earn, unjust

profits from the trade, etc. of such derivatives.

Article 443 of the current Financial Investment Services and Capital Markets Act (Penalty Provisions)

(1) Any of the following persons shall be punished by imprisonment with labor for up to ten years or by a fine equivalent to two to five times the profit accrued or loss avoided by a violation: *Provided,* That where no profit accrued or loss is avoided by the violation, or it is impracticable to calculate such profit or loss, or where the amount equivalent to five times the profit accrued or loss avoided by a violation is not exceeding 500 million won, the upper limit of the fine shall be 500 million won: *<Amended by Act No. 11845, May 28, 2013; Act No. 12947, Dec. 30, 2014; Act No. 14827, Apr. 18, 2017>*

1. A person who uses, or allows a third person to use, material nonpublic information related to the business, etc. of a listed corporation in trading specific securities, etc. or any other transaction, in violation of Article 174 (1);
2. A person who uses, or allows a third person to use, nonpublic information related to commencing or discontinuing a tender offer for stocks, etc., in trading specific securities, etc. related to such stocks, etc. or any other transaction, in violation of Article 174 (2);
3. A person who uses, or allows a third to use, nonpublic information related to commencing or discontinuing acquisition or disposal of stocks, etc. in bulk in trading specific securities, etc. related to such stocks, etc. or any other transaction, in violation of Article 174 (3);
4. A person who misleads a third person, in violation of Article 176 (1), into misapprehending that the trading of listed securities or exchange-traded derivatives is escalating, or commits another offence set forth in any subparagraph of Article 176 (1) with intent to mislead the third person into making a wrong judgment;
5. A person who conducts any act set forth in any subparagraph of Article 176 (2), with intent to induce trading of listed securities or exchange-traded derivatives, in violation of the same paragraph;
6. A person who engages in a series of purchases or sales in connection with listed securities or exchange-traded derivatives or entrusting or being entrusted with such act with intent to fix or stabilize the market price of the listed securities or exchange-traded derivatives, in violation of Article 176 (3);
7. A person who commits an act set forth in any subparagraph of Article 176 (4) in connection with trading, etc. of securities or derivatives;
8. A person who commits an act set forth in any subparagraph of Article 178 (1) in connection with trading or other transaction of financial investment instruments (including public offering, private placement, and public sale of securities);
9. A person who disseminates any rumor, uses any deceptive scheme,

coerces any person by violence or threat with intent to trade or make any other transaction of financial investment securities (including public offering, private placement, and public sale of securities) or attempt to skew the market price, in violation of Article 178 (2).

(2) A punishment by imprisonment with labor under paragraph (1) shall be aggravated according to the following categories, if the profit accrued or loss avoided by a violation set forth in any subparagraph of paragraph (1) exceeds 500 million won:

1. Such person shall be sentenced to imprisonment with labor for between five years and life, if the amount of profit or avoided loss is at least five billion won;

2. Such person shall be sentenced to imprisonment with labor for a limited term of at least three years, if the amount of profit or avoided loss is at least 500 million won, but not exceeding five billion won.

【Reference Cases】 Supreme Court Decisions 2001Do606 (Gong2004Sang, 192), Dec. 12, 2003; 2011Do8109 (Gong2011Ha, 2504), Oct. 27, 2011; 2011Do15056 (Gong2013Ha, 1534), Jul. 11, 2013

【Defendant】 Defendant 1 and three others

【Appellant】 Defendants

【Attorney】 Attorneys Park Tae-wan et al.

【Judgment of the court below】 Seoul High Court Decision 2017No3609 decided May 18, 2018

【Disposition】 The part of the lower judgment against Defendants 1 and 2 is reversed, and the case is remanded to the Seoul High Court. The appeals filed by Defendants 4 and 3 are dismissed.

【Reasoning】 The grounds of appeal are examined (to the extent of supplement in case of supplemental appellate briefs not timely filed).

1. Defendant 1, Defendant 4

A. As to the Defendants' violation of the former Financial Investment Services and Capital Markets act (amended by Act No. 11845, May 28, 2013) (hereinafter "Capital Markets Act")

The lower court found Defendant 1 and Defendant 4 guilty on the violation of the Capital Markets Act, except for the part in the reasoning where they were found not guilty, holding that: (a) Defendants 1 and 4 conspired, as alleged in the facts charged, to engage in market price manipulation by artificially raising stock prices; and (b) in the process of doing so, acquired illegal gains by selling stocks acquired from exercising the securities from the preemptive right to new stocks, issued by Nonindicted Company 1.

Examining the reasoning of the lower judgment in light of the evidence duly admitted and the relevant legal principles, the lower court did not err by exceeding the bounds of the principle of free evaluation of evidence inconsistent with the logical and empirical rules and failing to exhaust all necessary deliberations, or by misapprehending the relevant legal principles and omitting judgments, as alleged in the ground of appeal.

B. As to Defendant 1's violation of the Act on the Aggravated Punishment, Etc. of Specific Economic Crimes (Fraud) (hereinafter "Specific Economic Crimes Act")

The lower court found Defendant 1 guilty on the facts charged of violating the Specific Economic Crimes Act (Fraud). Examining the reasoning of the lower judgment in light of the evidence duly adopted and the relevant legal principles, the lower court did not err by exceeding the bounds of the principle of free evaluation of evidence in breach of the logical and empirical rules, or by misapprehending the legal principle on the intention of fraud and deception.

2. Defendant 3

The argument that the lower court's sentencing adjudication is unlawful, because of the violation of the rules of evidence, mistake of facts, and failure to take all necessary deliberations, constitutes the argument of improper sentencing. According to Article 383 Subparag. 4 of the Criminal Procedure Act, a final appeal may be lodged against a judgment of the lower court on the ground of improper sentencing, regarding those cases for which death penalty or imprisonment, with or without labor, for an indefinite term or for not less than ten years has been declared. As such, considering that Defendant 3 in the instant case was sentenced with a lighter punishment than what is stipulated under the relevant provision, neither the argument of an erroneous judgment of the lower court nor the argument of extremely inappropriate punishment serves as the appropriate ground of appeal.

3. Defendant 2

A. Market price manipulation in 2009

The lower court found Defendant 2 guilty on the charge of violating the 2009 Capital Markets Act, where he/she artificially raised the stock price of Nonindicted Company 1, and in the process of doing so, obtained illegal gains by selling stocks acquired from exercising the securities from the preemptive right to new stocks, issued by Nonindicted Company 1.

Examining the reasoning of the lower judgment in light of the evidence duly adopted and the relevant legal principles, the lower court did not err by exceeding the bounds of the principle of free evaluation of evidence in breach of the logical and empirical rules, or by misapprehending the legal principles regarding the establishment of accomplice liability, the accounts used in price manipulation, and the causal relationship.

B. Market price manipulation in 2012

(1) The former Financial Investment Services and Capital Markets Act

(amended by Act No. 11845, May 28, 2013) (hereinafter "Capital Markets Act") prohibits market price manipulation (Article 176) and imposes criminal punishment on any person who violates pertinent provision (Article 443). The Capital Markets Act imposes aggravated punishment depending on the amount equivalent to "the gain accrued from or loss avoided by the violation," which is defined as one of the constituting elements of crime (Article 443(1) proviso and Article 443(2)). As such, its application warrants caution to ensure (i) the legality principle, which ensures a reasonable balance between a crime and a punishment through strict and cautious calculation of the gains accrued from the violation, and (ii) the responsibility principle, which demands that a punishment must be based on and proportionate to the attendant responsibility (*see, e.g.,* Supreme Court Decision 2011Do8109, Oct. 27, 2011).

"The gain accrued from the violation" refers to the whole of gains from the causal relationship generated by a manipulator's violation, which encompasses both (a) the gains already accrued as a result of specific transactions during the period of market price manipulation (hereinafter "realized gain") and (b) the assessed gain of the stocks or the securities from the preemptive right to new stocks, both of which subject to market price manipulation, in possession at the end of the pertinent market price manipulation (hereinafter "unrealized gain") (*see, e.g.,* Supreme Court Decisions 2001Do606, Dec. 12, 2003; 2011Do15056, Jul. 11, 2013).

In a case where a surge in stock price is caused by market price manipulation, the realized gain therefrom is calculated as follows: [(the difference between selling price per unit and buying price per unit) × (among the quantity of stocks bought and the quantity of stocks sold, those with smaller quantity ("matched quantity of stocks bought and sold"))] – (transaction cost at the time of the disposal of the stocks). Where stock acquisition was intended for acquiring gains from market price manipulation, the outcome of the weighted average of the actual purchase amount by the number of stocks bought would be the buying price per unit; where the disposed stocks were issued from the securities from the preemptive right to new stocks, the buying price per unit would be equivalent to the outcome of the weighted average of the sum of the strike price of the preemptive right to new stocks and the purchase amount of the securities from the preemptive right to new stocks (hereinafter "purchase price of the preemptive right to new stocks") by the number of stocks bought.

However, if the acquisition of the stocks or the securities from the preemptive right to new stocks was not intended for obtaining gains through market price manipulation, the stock's closing price on the day preceding the period of market price manipulation should be deemed as the buying price per unit. This is because the purchase price of the previously possessed stocks or the preemptive right to new stocks is irrelevant to market price manipulation.

After all, if the stock's closing price on the day preceding the period of market price manipulation (hereinafter "closing price before market price manipulation") is set at a higher price than the purchase price of the previously possessed stocks or the preemptive right to new stocks, due to either regular price fluctuations or fluctuations irrelevant to a manipulator, the gain equivalent to the difference between the closing price before market price manipulation and the purchase price of the previously possessed stocks or the preemptive right to new stocks is deemed to have been accrued irrespective of market price manipulation, and thus, cannot be deemed as "the gain accrued from the violation." On the other hand, where the stock's closing price on the day preceding the period of market price manipulation had been set at lower price than the purchase price of the stocks or the preemptive right to new stocks, and later increased to higher levels than the purchase price of the stocks or the preemptive right to new stocks because of market price manipulation, the gain equivalent to the difference between the purchase price of the stocks or the preemptive right to new stocks and the stock's closing price on the day preceding the period of market price manipulation is attributable to market price manipulation, and thus, constitutes "the gain accrued from the violation."

In the meantime, where stocks are sold during the period of market price manipulation, selling price per unit should be determined by computing the weighted average of the actual sell amount by the quantity of stocks sold.

(2) According to the reasoning of the lower judgment, following facts are revealed.

(A) On around January 5, 2011, Defendant 1 invested in Nonindicted Company 1 by means of buying the bonds with stock warrants through Nonindicted Company 2 Co., Ltd (hereinafter "Nonindicted Company 2") which he/she had been operating at the time. However, around February 2011, Nonindicted Company 1's stock price dropped significantly, and upon the knowledge of weak financial condition of Nonindicted Company 1, Defendant 1 acquired management control of Nonindicted Company 1 in around July 2011 so as to recover the investment money by first overhauling the financial structure and then selling back the management right.

(B) Defendant 2 and Defendant 1 conspired with Nonindicted 3 and Nonindicted 4 to artificially raise the stock price of Nonindicted Company 1 in around April 2012, to sell the stocks issued from exercising the securities from the preemptive right to new stocks that was issued by Nonindicted Company 1, by then was owned by Nonindicted Company 2, to allow (a) the parties exercising the securities from the preemptive right to obtain the profits from the selling of the stocks; and (b) Nonindicted Company 1 to raise the fund to operate the company from the payment of strike price of the securities from the preemptive right to new stocks, thereby resolving the financial issues. From May 2, 2012 to July 27, 2012, the Defendants: (a) engaged in a wash trade or a matched trade with the aim of falsely creating the appearance of active trading or misleading other persons to make wrong investment decisions; (b) with the aim of instigating trading of stocks, (i) placed buy orders at higher prices, (ii) set orders with a view to limiting the number of available stocks, (iii) placed false orders, and (iv) manipulated the closing price. Furthermore, Defendant 4: (a) appeared in a TV program recommending the stocks of Nonindicted Company 1 since June 12, 2012; (b) around the same period, solicited paid-up members of online stock trading site to buy the stocks of Nonindicted Company 1, thereby attracting buy orders; and (c) until early August 2012, solicited these members to hold on to the stocks of Nonindicted Company 1.

(C) The strike price of the preemptive right to new stocks was set at KRW 500. The closing price of Nonindicted Company 1 stock on April 30, 2012, the day preceding the beginning of the period of market price manipulation, was at KRW 980. The closing price of Nonindicted Company 1 stock rose to KRW 1,810 (the highest price point being KRW 1,930) on June 27, 2012 due to market price manipulation.

(3) In light of the legal principles and factual matters seen earlier, the gain obtained by Defendant 1 and Defendant 2 from market price manipulation should be determined based on the buying price per unit, which can be calculated by computing the weighted average of, either the pertinent share's closing price on the day preceding the period of market price manipulation, or the purchase price of the preemptive right to new stocks, by the quantity of shares bought, depending on whether the Defendants possessed the securities from the preemptive right to new stocks with the aim of obtaining gains from market price manipulation.

Yet, the lower court calculated the gain accrued from market price manipulation acquired by Defendant 1 and Defendant 2 by applying the strike price of the preemptive right to new stocks, set at KRW 500, as the buying price per unit. Such a judgment of the lower court is erroneous in that it misapprehended the legal principle regarding "the gain accrued from the violation" as stipulated in Article 443(1) proviso and Article 443(2) of the Capital Markets Act. The ground of appeal on this point is with merit.

4. The scope of the reversal of the lower judgment

A. The part on Defendant 2's violation of the 2012 Capital Markets Act in the lower judgment ought to be reversed. Since the relevant part is in a concurrent relationship, as stipulated in the former part of Article 37 of the Criminal Act, with the part on the violation of the 2009 Capital Markets Act, requiring a single punishment for all of these violations, the part on Defendant 2 in the lower judgment must entirely be reversed.

B. The reason for reversing the part on Defendant 2's violation of the 2012 Capital Markets Act applies likewise to Defendant 1. Therefore, the relevant part regarding Defendant 1 in the lower judgment should be accordingly reversed pursuant to Article 392 of the Criminal Procedure Act. Since the relevant part is in a concurrent relationship, as stipulated in the former part of Article 37 of the Criminal Act, with the part on the violation of the 2009 and 2013 Capital Markets Act, respectively, as well as with the part on the violation of the Act on the Aggravated Punishment, Etc. of Specific Economic Crimes (Fraud), requiring a single punishment for all of these violations, the remaining part on Defendant 1 in the lower judgment must be reversed correspondingly.

5. Conclusion

The part on Defendant 1 and Defendant 2 in the lower judgment is reversed and remanded to Seoul High Court for further proceedings consistent with this Opinion. The appeal filed by Defendant 4 and Defendant 3 is dismissed. It is so decided as per Disposition by the assent of all participating Justices on the bench.

Justices Lee Dong-won (Presiding Justice)
Jo Hee-de
Kim Jae-hyung (Justice in charge)
Min You-sook

Supreme Court en banc Decision 2016Da220143 Decided October 18, 2018

【Return of Security Deposits for Membership】

【Main Issue and Holding】

In a case where an essential sports facility, which is subject to a security trust agreement, is transferred *en bloc* through either sale proceedings by an open competitive bid process or a negotiated contract, pursuant to what is prescribed under the relevant security trust agreement, whether a person acquiring the facility succeeds to the rights and obligations entailed by the registration and reporting of sports facility business, including matters agreed upon between the sports facility business entity and its members (affirmative)

【Summary of Decision】

[Majority Opinion] Article 27(1) of the Installation and Utilization of Sports Facilities Act (hereinafter "Sports Facilities Act") states, "[w]hen any sports facility entity dies or transfers his/her business or [when] corporate sports facility business entity is merged, the successor, the person who acquires the business, the corporation surviving the merger, or the corporation incorporated by the merger shall succeed to the rights and obligations upon the registration or reporting of the relevant sports facility business (including matters agreed upon between the sports facility business entity and his/her members where members are recruited under Article 17)." In addition, Article 26(2) of the Act stipulates, "[p]aragraph (1) shall apply *mutatis mutandis* to any person who acquires essential facilities in compliance with the facility standards for sports facility business prescribed by Ordinance of the Ministry of Culture, Sports and Tourism according to any of the following procedures," and delineates the procedures as follows: auction pursuant to the Civil Execution Act (Subparag. 1); conversion pursuant to the Debtor Rehabilitation and Bankruptcy Act (Subparag. 2); sale of seized property pursuant to the National Tax Collection Act, the Customs Act, or the Local Tax Collection Act (Subparag. 3); and other procedures corresponding to subparagraphs 1 through 3 (Subparag. 4).

As noted *supra*, Article 27(1) of the Sports Facilities Act provides that the rights and obligations entailed by the registration and reporting of sports facility business are transferred not only in cases of inheritance and merger but also in cases involving business transfer. Furthermore, Article 27(2) sets forth that Parag. (1) applies *mutatis mutandis* to any person who acquired essential facilities in compliance with the facility standards for sports facility business (hereinafter "essential sports facilities") through an auction or similar process.

Where sport facility businesses or essential sports facilities are transferred to other persons, a business transferee or a person assuming control over the essential sports facilities succeeds not only to the rights and obligations of the relevant sports facility business under public law, but also the rights and obligations arising from the private agreement between the sports facility business entity and its members.

There are instances where a sports facility business entity creates a security trust on an essential sports facility, but fails to pay back a loan. In such cases, the essential sports facility is disposed of, either through sale proceedings by an open competitive bid process (hereinafter "public sale") or through a negotiated contract in compliance with the conditions of public sale set forth in the public sale process. At issue in the instant case, where an essential sports facility, which is subject to a security trust agreement for security purposes, is transferred *en bloc* pursuant to a public sale or a negotiated contract prescribed under the relevant trust agreement, is whether a person acquiring the facility also succeeds to the rights and obligations towards the members of the relevant sports facility.

In such a case, the transferee of the essential sports facility business shall be deemed to succeed to the rights and obligations upon the registration or reporting of the relevant sports facility business, including matters agreed upon between the sport facility business entity and its members, by fully viewing the language and structure, the legislative history and purpose of Article 27 of the Sports Facilities Act, and the practical function of security trust.

[Dissenting Opinion by Justice Jo Hee-de, Justice Kwon Soon-il, Justice Min You-sook, Justice Lee Dong-won] A person acquiring an essential sports facility through sale, which is based on either an open competitive bid process or a negotiated contract, pursuant to what is prescribed under a security trust agreement (hereinafter "sale based on security trust") shall be deemed not to succeed to the rights and obligations upon the registration or reporting of the relevant sports facility business. Moreover, such sale proceedings shall not be deemed to conform to "other procedures corresponding to subparagraphs 1 through 3," as stipulated under Article 27(2) Subparag. 4 of the Sports Facilities Act.

The legal nature of a sale based on security trust is entirely distinguishable from (a) transfer of business or merger, stated in Article 27(1) of the Sports Facilities Act; and (b) auction under the Civil Execution Act, stipulated in Article 27(2) Subparags. 1 through 3, in terms of its governing entity, procedures, and the manner of distribution of sale proceeds.

A debtor's property may be transferred to a third party for myriad purposes; however, it is a general legal principle that the obligations borne by the debtor may not be inherited by the third party that acquired ownership of the relevant property. An applicable provision placed under Article 27 of the Sports Facilities Act regarding succession of the obligation of a sports facility business entity is an exception to such a legal principle. Hence, when the interpretation of the exceptional provision is inadequately explicit, one must resort to a general legal principle, instead of extensively interpreting the exceptional provision.

Article 27(2) Subparag. 4 of the Sports Facilities Act is a provision that presumes the procedures similar in nature to the procedures stipulated under Subparags. 1 through 3 under Article 27(2) of the Act. As such, a more natural and literal interpretation is that the relevant provision is applied when: (a) there is a specific statutory provision regarding the relevant procedure itself; and (b) the procedure is overseen by the courts, public institutions, or an official trustee.

【Reference Provision】 Article 27 of the Installation and Utilization of Sports Facilities Act

Article 27 of the Sports Facilities Act (Succession of Sports Facility Business, etc.)

(1) When any sports facility business entity dies or transfers his/her business or corporate sports facility business entity is merged, the successor, the person who acquires the business, the corporation surviving the merger, or the corporation incorporated by the merger shall succeed to the rights and duties upon the registration or reporting of the relevant sports facility business (including matters agreed upon between the sports facility business entity and his/her members where members are recruited under Article 17).

(2) Paragraph (1) shall apply *mutatis mutandis* to any person who acquires essential facilities in compliance with the facility standards for sports facility business prescribed by Ordinance of the Ministry of Culture, Sports and Tourism according to any of the following procedures: *<Amended by Act No. 8852, Feb. 29, 2008; Act No. 10219, Mar. 31, 2010; Act No. 14476, Dec. 27, 2016>*

1. Auction pursuant to the Civil Execution Act;
2. Conversion pursuant to the Debtor Rehabilitation and Bankruptcy Act;
3. Sale of seized property pursuant to the National Tax Collection Act, the Customs Act, or the Local Tax Collection Act;
4. Other procedures corresponding to subparagraphs 1 through 3.

(3) Paragraphs (1) and (2) shall apply *mutatis mutandis* to the succession of approval of a business plan under Article 12.

【Plaintiff-Appellant】 Plaintiff 1 and ten others (Barun Law LLC, Attorneys Park Il-hwan et al., Counsel for the plaintiff-appellant)

【Defendant-Appellee】 Daom Co., Ltd and two others (Bae, Kim & Lee LLC et al., Counsel for the defendant-appellee)

【Judgment of the court below】 Daegu High Court Decision 2015Na22107 decided April 21, 2016

【Disposition】 The lower judgment is reversed, and the case is remanded to Daegu High Court.

【Reasoning】 The ground of the final appeal is examined.

1. Article 27(1) of the Installation and Utilization of Sports Facilities Act (hereinafter "Sports Facilities Act") states, "[w]hen any sports facility entity dies or transfers his/her business or [when] corporate sports facility business entity is merged, the successor, the person who acquires the business, the corporation surviving the merger, or the corporation incorporated by the merger shall succeed to the rights and obligations upon the registration or reporting of the relevant sports facility business (including matters agreed upon between the sports facility business entity and his/her members where members are recruited under Article 17)." In addition, Article 26(2) of the Act stipulates, "[p]aragraph (1) shall apply *mutatis mutandis* to any person who acquires essential facilities in compliance with the facility standards for sports facility business prescribed by Ordinance of the Ministry of Culture, Sports and Tourism according to any of the following procedures," and delineates the procedures as follows: auction pursuant to the Civil Execution Act (Subparag. 1); conversion pursuant to the Debtor Rehabilitation and Bankruptcy Act (Subparag. 2); sale of seized property pursuant to the National Tax Collection Act, the Customs Act, or the Local Tax Collection Act (Subparag. 3); and other procedures corresponding to subparagraphs 1 through 3 (Subparag. 4).

As noted *supra*, Article 27(1) of the Sports Facilities Act provides that the rights and obligations entailed by the registration and reporting of sports facility business are transferred not only in cases of inheritance and merger but also in cases involving business transfer. Furthermore, Article 27(2) sets forth that Parag. (1) applies *mutatis mutandis* to any person who acquired essential facilities in compliance with the facility standards for sports facility business (hereinafter "essential sports facilities") through an auction or similar process. Where sport facility businesses or essential sports facilities are transferred to other persons, a business transferee or a person assuming control over the essential sports facilities succeeds not only to the rights and obligations of the relevant sports facility business under public law, but also the rights and obligations arising from the private agreement between the sports facility business entity and its members.

There are instances where a sports facility business entity creates a security trust on an essential sports facility, but fails to pay back a loan. In such cases, the essential sports facility is disposed of, either through sale proceedings by an open competitive bid process (hereinafter "public sale") or through a negotiated contract in compliance with the conditions of public sale set forth in the public sale process. At issue in the instant case, where an essential sports facility, which is subject to a security trust agreement for security purposes, is transferred *en bloc* pursuant to a public sale or a negotiated contract prescribed under the relevant trust agreement, is whether a person acquiring the facility also succeeds to the rights and obligations towards the members of the relevant sports facility.

In such a case, the transferee of the essential sports facility business shall be deemed to succeed to the rights and obligations upon the registration or reporting of the relevant sports facility business, including matters agreed upon between the sport facility business entity and its members, by fully viewing the language and structure, the legislative history and purpose of Article 27 of the Sports Facilities Act, and the practical function of security trust. We further elaborate this in detail.

A. Where an essential sports facility is transferred *en bloc* to a transferee, the rights and obligations towards its members shall be considered to be inherited by the transferee as well. This view conforms to the legislative purpose of the relevant provision.

Article 27 of the Sports Facilities Act intends to maintain supervisory systems under public law towards a sports facility business entity, forged in relation to business approval and permission, independent of the change in its business entity. Also, it allows an exception to the terms regarding general business transfer or an auction procedure so as to protect the interests of a large group of members who entered into an agreement to use the relevant sports facility (*see, e.g.,* Supreme Court Decision 2013Da85417, Dec. 23, 2015; Supreme Court Order 2014Ma1427, May 25, 2016).

In general, a business transfer refers to the transfer of the entire personnel and physical assets organized to conduct business while assuring its continuity. Yet, a business transfer under Article 27 of the Sports Facilities Act includes "transfer of the entirety of the relevant business' personnel and physical assets, while assuring continuity of the business, organized with the aim of being registered as a sports facility business upon completion of the construction of a sports facility in the future (*see, e.g.,* Supreme Court Decision 2004Da10213, Oct. 28, 2004). In a case where: (a) a person acquires a part of business assets through an auction held to exercise a security right, and acquires subsequently from the former business entity the remaining business assets and assumes control of the business by a separate transfer agreement, (b) and, does so with the sole intention of succeeding to and continuing the business, which is being performed for the purpose of registering it as a sports facility business upon the completion of the construction, from the former business entity, (c) thereby establishing an exceptional circumstance in which the former business is deemed to have been transferred as a whole while maintaining its continuity from general perspective, the Supreme Court held that such a case constitutes a business transfer as stipulated in the relevant provision (*see, e.g.,* Supreme Court Decision 2005Da5379, Nov. 23, 2006). Such Supreme Court ruling broadly comprehends the notion of "transfer of business" with the aim to facilitate the installation and the use of sports facilities, and to grant stronger protection, compared to those granted to general creditors, to the members who have reached an agreement with a sports facility business entity for such aims.

When an essential sports facility is held in security trust, and grounds for disposal of the entrusted property, such as a sports facility business entity's nonperformance of obligation, arise thereafter, a trustee commences a public sale process pursuant to the security trust agreement. Under the public sale, an essential sports facility is transferred *en bloc*; hence, there is a need for recognizing the succession of the rights and obligations just as in the transfer of business under the Sports Facilities Act. The same need shall also be recognized for a negotiated contract on essential sports facilities, entered into based on the final conditions of the public sale upon the failure of the public sale procedure under the security trust agreement.

B. It conforms to the literal interpretation of the relevant provision to recognize the succession of the rights and obligations towards the members of the essential sports facilities in cases of the transfer of the essential sports facilities by a public sale or a negotiated contract pursuant to security trust.

Article 27(2) Subparag. 4 of the Sports Facilities Act provides for a very broad provision stating "other procedures corresponding to subparagraphs 1 through 3," that allows for procedures not stipulated under Subparags. 1 through 3 to be subject to the application of Article 27(2). Considering such legislative structure and content, the phrase "procedures corresponding to," under Article 27(2) Subparag. 4 of the Sports Facilities Act, need not be so narrowly construed. There is no substantial distinction between a public sale and an auction under the Civil Procedure Act in that a public sale consists of ownership transfer by a compulsory realization procedure, which is carried out irrespective of the wishes of a sports facility business entity. In addition, a public sale is practically the same as a negotiated contract on an essential sports facility, entered into based on the final conditions of the public sale upon the failure of a public sale under the security trust agreement. Accordingly, such a public sale process or a negotiated contract may be considered to constitute "other procedures corresponding to subparagraphs 1 through 3" as stipulated in Article 27(2) Subparag. 4 of the Sports Facilities Act.

C. The alignment of the above interpretation with the legislative intent of the relevant provision is inferable from its legislative history and process.

At the time of the enactment of the Sports Facilities Act, there was no provision relating to succession of the rights and obligations pursuant to a sports facility business entity's transfer of business until a provision was introduced under Article 30(1) upon the fundamental revision of the Sports Facilities Act by Act No. 4719, Jan. 7, 1994. The provision on succession of the rights and obligations in accordance with an auction under the Civil Execution Act was introduced *de novo* under Article 30(2) with the amendment of the Sports Facilities Act by Act No. 6907 on May 29, 2003. These provisions were amended into Articles 27(1) and (2) of the former Sports Facilities Act upon the fundamental revision of the Sports Facilities Act by Act No. 8349 on April 11, 2007, and remains as is to this day.

The provision regarding succession by an auction under the Civil Execution Act was legislated, which, at the time of its introduction, referenced the legislative structure and content of (i) Article 8(2) of the former Public Health Control Act (amended by Act No. 3822, May 10, 1986); (ii) Article 13(4) of the former Tourism Promotion Act (amended by Act No. 4645, Dec. 27, 1993); and (iii) Article 8(2) of the former Tourism Promotion Act (amended by Act No. 6633, Jan. 26, 2002).

It is inferable from the legislative history or legislative corpus on the relevant provision that, where an essential sports facility is transferred through business transfers, auctions, or similar procedures, the rights and obligations towards members of the transferred sports facility are considered to be inherited by a transferee in order to protect the members of the relevant facility.

D. In light of the function of security trust, there is no substantial difference between a public sale based on security trust and an auction to exercise a security right, such as a mortgage, that warrants divergent approaches.

(1) A public sale procedure conducted by reason of security trust and an auction conducted pursuant to the Civil Execution Act as stipulated in Article 27(2) Subparags. 1 through 3 of the Sports Facilities Act are fundamentally similar in that: ① both are either compulsory or non-voluntary realization of a debtor's property irrespective of the debtor's volition in order to secure payment of outstanding claims; ② commencement of the procedures is not dependent solely on the will of the stakeholders in that both need to be either (i) supervised or authorized by the court, or (ii) governed by the court or the relevant authority; ③ a public bid open to the general public must first be conducted; and ④ selling the relevant property pursuant to discretionary sale or a negotiated contract is permissible under certain requirements (voluntary sale under Articles 492 and 496 of the Debtor Rehabilitation and Bankruptcy Act; private contract under Article 62 of the National Tax Collection Act; negotiated contract under Article 210(3) of the Customs Act; and private contract under Article 72 of the Local Tax Collection Act).

(2) A public sale conducted by reason of is distinguishable from an auction held to exercise a security right (e.g. mortgage), in that: (a) the procedure commences after the ownership of the trust property is transferred to a trustee; and (b) limited real rights do not cease to exist upon disposition of trust property by public sale. However, such difference may not be viewed as fundamental. A transfer of ownership to a trustee is a measure for maintaining and preserving the value of the trust property as a security; it is a trustor that still uses and profits from the trust property, while operating the business. Also, in the event of nonperformance of obligation, a trustee is obliged to undertake a public sale procedure in accordance with a security trust agreement, and shall not dispose of the property by other means. In the meantime, extinction of limited real right due to such reasons as an auction is attributable to the adoption of the so-called "theory of extinction" in the Civil Execution Act. Moreover, Article 27(2) of the Sports Facilities Act does not necessarily presuppose exclusively a

procedure to extinguish limited real rights.

In practice, a trustor holds an essential sports facility in security trust in the form of a trustor transferring ownership to a trustee in order to raise capital for the acquisition and operation of an essential sports facility. When a debtor-trustor does not fulfill his/her obligation, the ownership of an essential sports facility is transferred through a compulsory realization procedure, such as public sale of the trust property, depending on the wishes of creditors which does not take account of the wishes of the debtor. Accordingly, security trust on an essential sports facility in practice serves a similar role as a security right, such as a mortgage.

Denying the succession of the obligation to refund membership security deposits to the members of a sports facility in a public sale process conducted by reason of security trust would make a leeway for a sports facility business entity or a financial company to evade the application of Article 27(2) of the Sports Facilities Act, resulting in an unreasonable consequence that a person acquiring the relevant essential sports facility does not acquire the obligation to refund membership security deposits although the economic value of the sports facility increased because of the members' payment of fees for membership.

(3) A security trust is similar with the fiduciary transfer, which is used for the purpose of security by transferring rights (e.g. ownership), in terms of the method of the establishment of ownership transfer. In other words, security trust, under which a trustee receives ownership of real property held in trust (hereinafter "trusted real property") from a trustor-debtor, restricts a debtor's authority to dispose of property in order to ensure fulfillment of the purpose of securing a claim. The disposition of the trusted real property held in a security trust proceeds without restoring the ownership back to the debtor. In cases where an essential sports facility is transferred under fiduciary transfer or provisional registration is established thereon to secure payment of a loan claim, there is the possibility of the application of Article 27(2) Subparags. 1 or 4 of the Sports Facilities Act when the relevant security by transfer or provisional registration takes effect (Article 3 of the Provisional Registration Security Act provides relevant provisions concerning the exercise of a security right with respect to fiduciary transfer of real property or provisional registration security; Article 12 especially stipulates that any person having the right to a provisional registration for security may, on his/her will, exercise the security right under Article 3, or request an auction of secured real estate). If Article 27(2) Subparags. 1 or 4 of the Act are deemed applicable, Article 27(2) of the Sports Facilities Act is likewise be applicable to the public sale and the negotiated contract based on security trust, just as it is for the execution of fiduciary transfer, insofar as the security trust and the fiduciary transfer are considered practically identical in that (i) both are established for the purpose of securing the performance of a claim, and that (ii) registration of ownership transfer is completed at the time of the establishment.

(4) Trust affairs shall be governed by the court (Article 64(1) of the former Trust Act (amended by Act No. 10924, Jul. 25, 2011)) (this is also stipulated in Article 105(1) of the current Trust Act). However, the same shall not apply where the acceptance of the trust is carried on as a business (*see, e.g.,* Article 64(1) proviso of the former Trust Act; Article 105(1) of the current Trust Act). Where the acceptance of the trust is carried on as a business, such business must be overseen by the Financial Services Commission pursuant to Article 415 of the Financial Investment Services and Capital Markets Act, and is subject to the court's supervision as regards the matters within the purview of the court pursuant to the Trust Act (*see, e.g.,* Article 105(2) of the Trust Act). A public sale or a negotiated contract under a security trust agreement is distinguishable from general sale in that both are subject to supervision of the court or the Financial Services Commission.

A security trust agreement used in general provides that "disposition of trusted property upon default of an obligation shall be based on competitive bid (public sale). *Provided,* That upon failure of the public sale, a negotiated contract may be concluded based on the same conditions as those attached to the public sale immediately preceding the relevant public sale until before the date of the next public sale is announced." There may be instances where negotiated contracts based on security trust are considered as distinct from auction; however, Article 27(2) Subparags. 1 through 3 of the Sports Facilities Act already allow for discretionary sales or negotiated contracts. Also, in a case where a debtor defaults in performance of the secured obligations after establishing fiduciary transfer of or provisional registration security on an essential sports facility, a security right may be exercised by means of settlement through reversion or settlement through disposition, instead of an auction. These procedures can be subject to the application of Article 27(2) Subparags. 1 or 4 of the Sports Facilities Act. As such, there exists no reason to deny recognition of rightful succession regarding a public sale or a negotiated contract based on security trust as stipulated in Article 27 of the Sports Facilities Act.

Realization by trustees in bankruptcy pursuant to the Debtor Rehabilitation and Bankruptcy Act and negotiated contracts by a trustee based on security trust share many commonalities in terms of procedure and method. Thus, whether to apply Article 27(2) of the Sports Facilities Act with respect to the above two procedures ought to be the same. Both procedures are similar in that they (i) commence against the volition of a debtor; (ii) are overseen by an entity owing fiduciary duties; and (iii) are intended to satisfy creditors by ensuring recovery of a claim.

E. From the perspective of balancing of interests, restricting the effect of bankruptcy remoteness to some extent in a public sale process conducted by reason of security trust is reasonable, as doing so recognizes the inheritance of the rights and obligations, including the obligation to return membership security deposits, by a transferee of an essential sports facility.

Article 27 of the Sports Facilities Act recognizes the inheritance of the rights and obligations, including the obligation to return security deposits for participation, by a transferee of an essential sports facility so as to protect the rights and interests of the members therein. The same is also recognized in cases where a sports facility business entity is (i) depleted of financial means to satisfy the claims of creditors; or (ii) insolvent or on the brink of bankruptcy, giving rise to the commencement of bankruptcy or rehabilitation proceedings.

In a security trust agreement on sports facilities, the method of disposition of the relevant facility is pre-determined and the content of a sale contract pursuant to the agreed disposition is disclosed in advance through notification of public sale. As such, a public sale and a negotiated contract based on security trust are an equitable and predictable proceeding, as likewise the proceedings stipulated under Article 27(2) Subparags. 1 through 3 of the Sports Facilities Act.

Article 17 of the Sports Facilities Act, Articles 17 and 18 of the Enforcement Decree of the said Act, and Articles 17-2 and 19 of the Enforcement Rule of the said Act stipulate matters pertaining to the period, methodologies, and process of membership recruitment, the total recruitment amount, and submission of the member recruitment plan, allowing a transferee of an essential sports facility to sufficiently estimate the total number of members to be succeeded pursuant to Article 27(2) of the Sports Facilities Act. Even in a case where a public sale and a negotiated contract based on security trust are considered to be included in the proceedings stipulated under Article 27(2) Subparag. 4 of the Sports Facilities Act, the preferred beneficiary of security trust is not necessarily deemed to suffer unanticipated loss.

One of the reasons for holding sports facilities in a security trust is to prevent general creditors from exercising their claims to the trusted property in a case where a trustor becomes insolvent, so as to protect the trustee and the beneficiary pursuant to the effect of bankruptcy remoteness. However, it is reasonable from the perspective of balancing of interests to prioritize the fulfillment of the legislative intent of Article 27 of the Sports Facilities Act, which is to protect the rights and interests of members of a sports facility, even if that requires modifying to some extent the effect of bankruptcy remoteness. Accordingly, the inheritance of the rights and obligations, including the obligation to return security deposits for membership, by a transferee of an essential sports facility may not be denied in a public sale process conducted by reason of security trust on the ground of the effect of bankruptcy remoteness.

F. In sum, Article 27 of the Sports Facilities Act intends to protect the rights and interests of members of an essential sports facility in the event of its transfer, by ensuring the transferee thereof succeeds to the rights and obligations with respect to its members. As the language and text of the said provision is comprehensively written, there is no problem regarding a public sale or a negotiated contract based on security trust under the said provision. Such an interpretation of the provision is not only in compliance with the legislative intent as manifested in legislative history, but also a more equitable resolution in light of the substance of security trust.

3. The reasoning of the lower court and the evidence duly adopted reveal the following.

A. Venezia Korea Co., Ltd (hereinafter “Venezia Korea”): (a) undertook to run a business by constructing and operating Venezia Korea Country Club (hereinafter “instant golf course”) on each parcel of land in the attachment to the lower judgment listing real property (hereinafter “instant land parcel”); (b) concluded a trust agreement on the instant land parcel with KEB Hana Bank Co., Ltd (hereinafter “Hana Bank”), designating Hana Bank as a trustee and other financial institutions as the preferred beneficiary, to secure the performance of loan obligations to financial institutions including Hana Bank; and (c) completed the registration of ownership transfer by reason of trust with respect to the instant land parcel to Hana Bank on the same day.

B. Subsequently, new buildings were built on the instant land parcel, including a golf clubhouse. Venezia Korea concluded a security trust agreement on five buildings within the instant golf course on July 12, 2012, and completed the registration of ownership transfer by reason of trust in the name of Hana Bank (the instant land parcel and five buildings on the golf course will hereinafter be referred to as “instant trusted real property”).

C. Hana Bank commenced a public sale proceeding on the instant trusted real property (hereinafter “instant public sale proceeding”) upon outstanding performance of the pertinent loan obligation.

D. On May 22, 2014, Hana Bank made a bid of KRW 1.41 billion in the instant public sale proceeding, and concluded a sale contract on the instant trusted real property with Nonparty who won the bid. The Nonparty, however, did not properly perform its obligation under the contract. On May 27, 2014, Hana Bank concluded a sale contract on the instant trusted real property in the form of a negotiated contract with a purchase price of KRW 1.41 billion with Defendant Daom Co., Ltd, which sought to operate the instant golf course (hereinafter “Defendant Daom”), and completed the registration of ownership transfer on the instant trusted real property on May 30, 2014.

E. Defendant Daom: (a) concluded a security trust agreement on the instant land parcel with Defendant Kukje Trust Co., Ltd (hereinafter “Defendant Kukje Trust”) by designating Defendant 3 as the preferred beneficiary on June 26, 2014; and (b) completed the registration of ownership transfer by reason of trust in the name of Defendant Kukje Trust on the instant land parcel on June 27, 2014.

F. Meanwhile, Venezia Korea: (a) was designated as a developer of the construction project of the instant golf club by the Mayor of Gimcheon on January 21, 2008; (b) received authorization on the instant construction project's plan; and (c) filed the conditional registration of a sports facility business (golf club business) with the Governor of North Gyeongsang Province on December 5, 2013. The Plaintiffs purchased membership of the instant golf club by making payment of a security deposit.

4. Examining such factual relationship in light of the legal principle noted earlier: (a) Defendant Daom's acquisition of the instant trusted real property (including essential facilities of the instant golf club) as property held in security trust through a public sale proceeding by means of a negotiated contract constitutes acquisition of an essential sports facility through "other procedures corresponding to subparagraphs 1 through 3" as stipulated in Article 27(2) Subparag. 4 of the Sports Facilities Act. Therefore, Defendant Daom ought to be considered to have succeeded to the obligation to return membership security deposits made by the members of Venezia Korea (hereinafter "Plaintiffs"), a former sports facility business entity of the instant golf club.

Yet, the lower court: (a) dismissed the Plaintiffs' claim against Defendant Daom for refund of the membership security deposits on the ground that "Defendant Daom shall not be deemed to have succeeded to the obligation to return membership security deposits to the Plaintiffs, because the instant sale contract did not satisfy the statutory provisions necessary to constitute procedures stipulated in Article 27(2) Subparag. 4 of the Sports Facilities Act;" and also (b) dismissed the Plaintiffs' claims against Defendant Kukje Trust and Defendant 3 for revocation of fraudulent act and restitution on the grounds that (i) Defendant Daom did not succeed to the obligation to return membership security deposits, and thus, (ii) there is no preserved claim for fraudulent act recognized for Defendant Daom. In so determining, the lower court made an erroneous judgment by misapprehending the legal principle regarding Article 27 of the Sports Facilities Act, thereby adversely affecting the conclusion of the judgment. The ground of appeal alleging error on the part of the lower judgment is justifiable.

Meanwhile, Supreme Court Decision 2012Da4817 Decided April 26, 2012, etc., which was referenced by the lower court as the ground for denying succession of the obligation to return membership security deposits, is inappropriate to be used as a reference in the instant case, for the said decision pertains to a case in which a trustor of security trust is not a sports facility business entity.

5. Therefore, the lower judgment is reversed without further proceeding to decide on the remaining grounds of appeal, and the case is remanded to the lower court for further proceedings. It is so decided as per Disposition by the assent of all participating Justices except for a dissent by Justices Jo Hee-de, Kwon Soon-il, Lee Ki-taik, Min You-sook, and Lee Dong-won, followed by a concurrence with the Majority Opinion by Justices Kim So-young and Kim Jae-hyung, and a concurrence by Justice Cho Jae-youn.

6. Dissenting Opinion by Justice Jo Hee-de, Justice Kwon Soon-il, Justice Lee Ki-taik, Justice Min You-sook, and Justice Lee Dong-won

A. The Majority Opinion recognizes inheritance of the rights and obligations by a person acquiring an essential sports facility upon the registration and reporting of the relevant essential sports facility, where an essential sports facility held in a security trust is disposed of by sale under an open competitive bid process or a negotiated contract. The Majority views that such a sale procedure may be deemed to constitute "other procedures corresponding to subparagraphs 1 through 3" as stipulated under Article 27(2) Subparag. 4 of the Sports Facilities Act.

However, <u>a person acquiring an essential sports facility through sale, which is based on either an open competitive bid process or a negotiated contract, pursuant to what is prescribed under a security trust agreement (hereinafter "sale based on security trust") shall be deemed not to succeed to the rights and obligations upon the registration or reporting of the relevant sports facility business. Moreover, such sale proceedings shall not be deemed to conform to "other procedures corresponding to subparagraphs 1 through 3," as stipulated under Article 27(2) Subparag. 4 of the Sports Facilities Act.</u> The reasons are as follows.

(1) The procedures stipulated under Article 27(2) Subparags. 1 through 3 of the Sports Facilities Act are concerned with procedure for disposition; the conditions of sale are not determined by arrangements between the relevant parties, but rather, they are determined either by legislation or by the court or related institutions based on relevant law. However, the Majority Opinion holds a view that the conditions of sale pertaining to the sale based on security trust must be prescribed by law, while recognizing that the sale based on security trust constitutes specific succession arising from legal action. The Majority's interpretation is not viable without legislation, and is difficult to be readily posited as the interpretation of a contractual relationship in private transactions.

(2) A sale based on security trust is distinct from the legal actions or procedures identified under Articles 27(1) and (2) of the Sports Facilities Act in its legal nature and hence, must be distinguished from these legal actions or procedures.

<u>The legal nature of a sale based on security trust is entirely distinguishable from (a) transfer of business or merger, stated in Article 27(1) of the Sports Facilities Act</u>.

<u>And it is also distinguishable from auction under the Civil Execution Act as stipulated in Article 27(2) Subparags. 1 through 3.</u> In other words, the sale based on security trust is determined in a trust agreement, and is governed by a trustee rather than a public institution such as a court. Also, while the sale based on security trust is conducted by means of a "public sale" as agreed upon in a trust agreement, there is no specific statutory provision stating the concept and procedure of a "public sale." On the contrary, an auction procedure under the

Civil Execution Act follows procedures stipulated in law. While the sale based on security trust is performed by a trustee upon receipt of sale proceeds, an auction under the Civil Execution Act is overseen by a public institution, such as a court, which takes charge of the entire procedure till distribution.

The Majority Opinion argues that Article 27(2) Subparag. 4 must be applied to the case of a sale based on security trust on the ground that (i) a trust business is governed by the court; and (ii) it is similar to realization by a trustee in bankruptcy. However, a trust business, which is administered by a trust company tasked with the acquisition of security trust, is not subject to the judicial oversight according to the proviso of Article 105(1) of the Trust Act. Also, a trustee in bankruptcy is a public trustee managing the disposition procedure upon the court's permission. Hence, the sale based on security trust cannot be seen as similar to realization by a trustee in bankruptcy.

(3) No obligation shall be placed without clear legal grounds.

A debtor's property may be transferred to a third party for myriad purposes; however, it is a general legal principle that the obligations borne by the debtor may not be inherited by the third party that acquired ownership of the relevant property. An applicable provision placed under Article 27 of the Sports Facilities Act regarding succession of the obligation of a sports facility business entity is an exception to such a legal principle. Hence, when the interpretation of the exceptional provision is inadequately explicit, one must resort to a general legal principle, instead of extensively interpreting the exceptional provision.

A sale based on security trust is conducted in a private sphere just like general sales, and as noted earlier, is distinguishable from an auction procedure under the Civil Execution Act. The Majority Opinion runs counter to the general legal principle seen above by extensively interpreting Article 27 of the Sports Facilities Act in the case of a sale based on security trust without reasonable grounds.

(4) The inapplicability of Article 27 of the Sports Facilities Act to a sale based on security trust, which results in the interpretation that the succession of the rights and obligations cannot be recognized, is a natural and literal interpretation of the relevant provision.

Although the sale of trusted real property held in security trust by means of an open competitive bid process is frequently referred to as a "public sale" in transactional practice, such public sale is simply a sale, which is indistinguishable from a general sale under law. There is no doubt as to the fact that Article 27 of the Sports Facilities Act does not apply to a general sale. The Majority Opinion is unjustifiable in that it recognizes succession of the rights and obligations only in the case of a sale regarding disposition of trusted property, among other types of sale.

The literal meaning of "other procedures corresponding to subparagraphs 1 through 3" as stated in Article 27(2) Subparag. 4 of the Sports Facilities Act is as follows. The relevant provision intends to ensure, where other laws invoke the procedures stipulated under Article 27(2) Subparags. 1 through 3 of the Sports Facilities Act, or explicitly adapt the provision providing for the procedures under Subparags. 1 through 3 of the Act, that such a disposition procedure is not excluded from the scope of the application of Article 27(2) of the Sports Facilities Act. In addition, <u>Article 27(2) Subparag. 4 of the Sports Facilities Act is a provision that presumes the procedures similar in nature to the procedures stipulated under Subparags. 1 through 3 under Article 27(2) of the Act. As such, a more natural and literal interpretation is that the relevant provision is applied when: (a) there is a specific statutory provision regarding the relevant procedure itself; and (b) the procedure is overseen by the courts, public institutions, or an official trustee.</u>

(5) The reasoning immediately above aligns with the legislative intent to exempt the application of Article 27(2) of the Sports Facilities Act in the sale of property held in a security trust.

Where there was discussion of a certain matter in the legislative procedure, which nonetheless did not lead to the enactment of a statutory provision, problems arising from matters unstipulated by a statutory provision, however valid the discussion may be, must be viewed as an expression of the legislative intent to exclude such matters from the application of law. Yet, in dealing with a case of the sale of an essential sports facility, the Majority Opinion views, as an exception, a sale regarding disposition of the property held in security trust as being subject to the relevant provision, which is in fact unstipulated in the relevant provision, and accordingly applies Article 27(2) of the Sports Facilities Act. In so doing, the Majority Opinion transcends the permissible bounds of statutory interpretation and commits an error that empowers the court to legislate, which does not fall within the purview of the judiciary.

(6) As one of the legislative intents behind Article 27(2) of the Sports Facilities Act is to ensure safety of transaction, the said provision must be strictly interpreted.

Considering that Article 27(2) does not regulate all transaction procedures where an essential sports facility is transferred to another person, but rather only an auction under the Civil Execution Act and the corresponding procedures, it is reasonable to view that the said provision also intends to ensure the security of transaction concerning acquisition of essential sports facilities by recognizing to a limited extent the succession of arrangements agreed upon under private law between a sports facility business entity and its members.

As seen above, Article 27(2) of the Sports Facilities Act aims to protect the legal status of the members of a sports facility, and ensure transaction security. Hence, it is imperative to strictly interpret the relevant provision. A broad interpretation of Article 27(2) Subparag. 4 of the Sports Facilities Act, as in the Majority Opinion, is likely to impose a heavy burden on the relevant real estate transaction, and lead to unsatisfactory fulfillment of a claim of creditors holding security due to the reduced transaction price. Furthermore, arguing for revocation of transaction on the ground that the existence of error in the important parts regarding future transactions, arising from the existence of uncertainty until before the instant decision as to succession of the rights and obligations is rendered, leaves room for such an argument to be accepted, giving rise to a new dispute with regard to the transaction and thus destabilizing the legal relationship among the parties to the transaction.

(7) Founded on the fact that there is no substantial difference between a sale based on security trust and the procedures stipulated under Article 27(2) Subparags. 1 through 3, the Majority Opinion's logic is grounded on the similarity among these procedures. However, the Majority Opinion does not provide clear predictability as to the succession of the obligation to return membership security deposits to a person who participates in disposition of an essential sports facility. In other words, according to the Majority Opinion, a participant of the disposition procedure is unable to predict to what extent and to which degree the disposition procedure of his/her choice has to be similar with the procedures stipulated under Subparags. 1 through 3, rendering it completely impossible to predict whether the relevant sale procedure is deemed to constitute the procedure stipulated under Subparag. 4 of the Act by which the obligation to return membership security deposits is inherited. The Majority Opinion attempted to determine by law the conditions of sale in cases of a specific succession by legal action, which puts the relevant parties to the transaction in a precarious position.

(8) Taking account of the characteristic of security trust, the Majority Opinion is unreasonable in that it passes the burden of a trustor, who is detached from the trusted property, to a third party acquiring an essential sports facility through the sale of the trusted property.

In a case of a sale based on security trust where a person takes over an essential sports facility held under the title of a trustee, it is hard to find legal grounds for recognizing natural succession of legal status under public law or the rights and obligations from the former sports facility business entity, a trustor, to the person who acquires the relevant facility without going through a trustee, the legal owner of the relevant sports essential facility.

Trusted property exists separate from a trustor's property as well as from the distinct property of a trustee, the owner of the relevant trust property. As such, the commencement of rehabilitation or bankruptcy proceedings would not affect a beneficiary's status or a security right established on the trust property. Therefore, a creditor, who has created a real right by way of security or acquired the right to benefit with respect to the independent property held in trust, is capable of acquiring guaranteed security which is completely protected from the risk of bankruptcy, borne by a person who provides security. If a third person is presumed to have naturally borne an obligation to consider the trustor's obligation to return membership security deposits to members of the relevant sports facility while conducting valuation of preferred rights to benefit, such an obligation directly contradicts the purpose of a trust, which aims to separate the trust property from a trustor's credit risk.

Also, it is hard to conclude that trust property is reasonably valuated under the presumption of succession of the rights and obligations upon the registration of a sports facility, or that such burden of succession is publicly announced.

(9) The Majority Opinion also argues that "denying the succession of the obligation to refund membership security deposits to the members of a sports facility in a public sale based on security trust would provide leeway for a sports facility business entity or a financial company to evade the application of Article 27(2) of the Sports Facilities Act, resulting in an unreasonable consequence that a person acquiring the relevant essential sports facility does not acquire the obligation to refund membership security deposits, although the economic value of the sports facility increased upon the members' payment of a membership fee." However, in cases where the conclusion of a security trust agreement constitutes a fraudulent trust harming the stakeholders, including members of the relevant sports facility, there are measures for seeking revocation and restitution on the ground that the relevant trust constitutes a fraudulent trust pursuant to Article 8 of the Trust Act. Therefore, the emergence of an unreasonable consequence may not be the grounds for justifying the application of Article 27(2) Subparag. 4 of the Sports Facilities Act in the case of a sale based on security trust as alleged in the Majority Opinion.

Furthermore, the Majority Opinion claims, "after an essential sports facility is designated as the object of fiduciary transfer or put to provisional registration security, the relevant security right may be exercised by means of settlement through reversion or settlement through disposition, instead of an auction. [T]hese procedures may be covered by Article 27(2) Subparags. 1 or 4 of the Sports Facilities Act." However, it is difficult to find any grounds that the fiduciary transfer of or entering into a provisional registration security is included in the procedures listed under Article 27(2) of the Sports Facilities Act.

(10) Lastly, the Majority Opinion's logic may give rise to an undesirable socioeconomic consequence.

Persons intent on purchasing essential sports facilities of a golf club in the sale based on security trust assess the property value of the relevant golf club by taking into account the succession of the obligation to return membership security deposits. According to the Majority Opinion, the relevant property is likely to be devalued, and the value might be reduced down to zero depending on individual cases.

By pursuing only the interests of the members, as argued in the Majority Opinion, the disposition of essential sports facilities of a golf club may become unfeasible. Time will lapse with the disposition being suspended, compounding the complexities of the creditors who are related to the sale of the said golf club and their economic interests, which cannot be resolved through a private platform, thereby leaving creditors with scant choices, i.e. taking recourse to rehabilitation or bankruptcy proceedings.

B. In sum, the lower judgment is justifiable in holding that "Defendant Daom's acquisition of the instant land parcel, which is an essential sports facility, by way of a negotiated contract in a sale based on security trust, does not constitute the procedures stipulated under Article 27(2) Subparag. 4 of the Sports Facilities Act; hence, Defendant Daom cannot be considered to have succeeded to the obligation to return membership security deposits to the Plaintiffs of Venezia Korea."

Furthermore, the lower court is also justifiable in ruling that "Defendant Daom may not be considered the person acquiring the business as stipulated in Article 27(1) of the Sports Facilities Act."

In so determining, the lower court did not render an erroneous judgment by misapprehending the legal principle on Article 27(2) of the Sports Facilities Act and the legal principle on a transfer of business as stated in Article 27(1) of the Act as alleged in the ground of appeal. Thus, the final appeal must be dismissed.

For the foregoing reasons, we dissent with the Majority Opinion.

7. Opinion Concurrent with the Majority Opinion by Justice Kim So-young and Justice Kim Jae-hyung

A. The gist of the instant case is as follows: in a case where a security trust agreement on an essential sports facility is concluded, and the relevant facility is transferred *en bloc* by a public sale or a negotiated contract as agreed in the relevant contract, whether the rights and obligations towards members of the relevant facility are also inherited by a person acquiring the business.

There are three approaches under which the aforementioned succession of the rights and obligations may be affirmed: (i) analogous application of Article 27(1) of the Sports Facilities Act; (ii) analogous application of Article 27(2) Subparags. 1 through 3; and (iii) inclusion into "other procedures corresponding to subparagraphs 1 through 3" under Article 27(2) Subparag. 4.

Since Article 27(2) Subparag. 4 of the Sports Facilities Act provides a comprehensive provision stipulating "other procedures corresponding to subparagraphs 1 through 3," Article 27(2) Subparag. 4 may be applied to resolve the issue, without employing an analogous application of Article 27(1) or Article 27(2) Subparags. 1 through 3.

Interpretation of statutes must adhere to the ordinary and plain meaning of the language and text used in pertinent provision. In addition, systematic and logical interpretation that takes into account (i) legislative intent and purpose; (ii) history of enactment and amendment; (iii) harmony with the entire legal order; and (iv) relationship with other statutes should also be used supplementarily (*see, e.g.,* Supreme Court Decision 2006Da81035, Apr. 23, 2009).

In the interpretation of statutes, possible meanings of the language and text must be examined. Viewing public sales or negotiated contracts as “other procedures corresponding to subparagraphs 1 through 3” does not exceed the bounds of the possible interpretations of the language and text. As noted in the Majority Opinion, inclusive interpretation of statutes, to the extent that it (i) does not exceed the bounds of possible interpretations of the language and text, (ii) seeks an equitable resolution of the issue, while remaining in compliance with the legislative purpose or intent, does not constitute a problematic approach to statutory interpretation.

B. The Dissenting Opinion argues that the Majority Opinion, without reasonable grounds, imposes obligations on persons acquiring an essential sports facility through a public sale or a negotiated contract based on security trust.

However, the obligations are imposed pursuant to Article 27 of the Sports Facilities Act. The Majority derives its ground from the interpretation of Article 27(2) Subparag. 4 of the Sports Facilities Act. Hence, it cannot be deemed that the obligations are imposed without legal grounds.

C. According to the Dissenting Opinion, a more natural and literal interpretation would be that Article 27(2) Subparag. 4 of the Sports Facilities Act applies when the procedure in question (a) is specifically stipulated under law; and (b) meets such requirements as being subject to the judicial oversight.

However, such interpretation exceeds the bounds of literal interpretation and constitutes a typical reduced teleological interpretation. The basis on which the Dissenting Opinion argues for the application of Article 27(2) Subparag. 4 of the Sports Facilities Act is not explicitly stated in the relevant provision. The Dissenting Opinion’s interpretation is based on what is unstipulated in law, thereby precluding the application of the relevant provision. Such interpretation is a teleological rather than a literal interpretation.

D. The Dissenting Opinion asserts that public sales or private contracts based on security trust are distinguishable from the procedures listed in Article 27(2) Subparags. 1 through 3 of the Sports Facilities Act in terms of legal nature. This assertion by the Dissenting Opinion is based on the claim that the procedures enumerated in Article 27(2) of the Sports Facilities Act are, unlike public sales or private contracts based on security trust, judicial procedures.

Nevertheless, that a certain process constitutes a judicial procedure, and the legal nature of the relevant procedure, are two unrelated subjects. Moreover, the legal nature of a public sale or a negotiated contract based on security trust cannot be deemed fundamentally different from an auction pursuant to the Civil Execution Act or realization by a trustee in bankruptcy through a discretionary sale.

In an auction procedure under the Civil Execution Act, the sale price is determined depending on the price bid by the highest price bidder. Hence, it cannot be denied that such an auction has the nature of a private sale. Precedents have also ruled that an auction under the Civil Execution Act is a type of sale (*see, e.g.,* Supreme Court Decision 91Da21640, Oct. 11, 1991), or that an auction has the nature of a private sale (*see, e.g.,* Supreme Court Decision 2012Da69197, Nov. 15, 2012). Also, precedents view that the realization procedure by a trustee in bankruptcy is in essence a private sale contract, and thus, is governed by private law principles, such as private autonomy and the principle of freedom of contract (*see, e.g.,* Supreme Court Decision 2010Da56265, Nov. 11, 2010). The negotiated disposition adopted by a trustee in bankruptcy is similar with a negotiated contract based on security trust in that both constitute a contract concluded with a specific party. As such, that the legal nature of both (i) an auction under the Civil Execution Act and (ii) realization by a trustee in bankruptcy through a discretionary sale is deemed a private sale is undeniable just because they are a judicial procedure.

A contract to which the State is a party is governed by the Act on Contracts to which the State is a Party; such a contract is also considered a contract under private law, concluded by the State as the subject of the private economy on an equal footing with the counterparty, and whose essence is indistinguishable from a contract between private persons (*see* Supreme Court en banc Decision 2012Da74076, Dec. 21, 2017).

Therefore, that a certain legal action or disposition process is stipulated under law is not related to the legal nature of that particular legal action or disposition process. Also, the legal nature of public sales or private contracts cannot be considered fundamentally distinguishable from the procedures listed in Article 27(2) Subparags. 1 through 3 under the Sports Facilities Act.

E. The Dissenting Opinion argues that: (i) non-application of Article 27(2) of the Sports Facilities Act to public sales or negotiated contracts based on security trust conforms to the legislative intent; and (ii) the Majority Opinion exceeds the permissible bounds of statutory interpretation, thereby empowering the court to legislate, which clearly does not fall within the purview of the court.

However, since Article 27(2) Subparag. 4 of the Sports Facilities Act uses a comprehensive term “procedures corresponding to,” it must be considered that the legislative intent is reflected in this open and comprehensive legislative format. The above provision only states “procedures corresponding to subparagraphs 1 through 3,” and does not state to the effect that “[the above provision] only applies to the procedures whose conditions of sale are stipulated under law or by the court pursuant to relevant legislation.” Thus, it cannot be considered that the Majority Opinion exceeded the permissible bounds of statutory interpretation.

F. According to the Dissenting Opinion, the legislative intent of Article 27(2) of the Sports Facilities Act includes “ensuring safety of transaction,” and thus, the relevant provision must be strictly interpreted.

However, the application of Article 27(2) Subparag. 4 to a public sale or a negotiated contract based on security trust does not necessarily lead to undermining the security of transaction. For example, a person seeking to purchase a golf club facility is able to predict the existence of membership and the obligation to return membership safety deposits. In addition, considering that the sports facilities-related legislation stipulates the methods of membership recruitment, the total recruitment amount, and submission of the member recruitment plan, a person intending to acquire essential sports facilities of a sports facility business that recruited members is at liberty to foresee the membership size (*see* Constitutional Court en banc Decision 2009Hun-Ba197, Jul. 29, 2010). Therefore, the Majority's interpretation would not compromise the security of transaction.

G. In accordance with the Dissenting Opinion, the Majority Opinion only pursues the interests of members, leaving no other alternatives for a company operating a golf club to resort to except for rehabilitation or bankruptcy proceedings.

However, it is not only reasonable but also aligns with our legal system to resolve conflicts of interests among creditors regarding companies with excessive liabilities through rehabilitation or bankruptcy proceedings. Resorting to the procedures or methods other than bankruptcy process in law to address the issue pertaining to insolvent businesses may cause serious confusion in the equitable settlement of conflicts of interests within the bankruptcy law. Likewise, it is better for a company running a golf club to undertake rehabilitation or bankruptcy proceedings, as doing so would likely to induce a reasonable settlement of conflicts of interests between the existing members and a person acquiring essential sports facilities.

For the foregoing reasons, we concur with the Majority Opinion.

8. Opinion Concurring with the Majority Opinion by Justice Cho Jae-youn

A. The Sports Facilities Act divides sports facility businesses into a registered sports facility business and a reported sports facility business. A golf club business is a registered sports facility business (Article 10(1)). Persons intent on operating a registered sports facility business are required to prepare a business plan prior to installation of their sports facilities and obtain approval therefor from the relevant Mayer/*Do* (provincial) Governor; and upon completion of installation of sports facilities, the said persons shall register the sports facility business with the Mayor/*Do* Governor before he/she commences the sports facility business (Articles 12 and 19). In sum, operating a golf club business necessitates the authorization of a business plan and the registration (hereinafter "license").

The Mayor/*Do* Governor may restrict the approval of a business plan where he/she deems it necessary for public welfare, such as for efficient utilization of national land, facilitation of the balanced regional development, prevention of disasters, conservation of the natural environment, and sound development of sports facility business (Article 13). Thus, getting a license of a golf club business requires overcoming various restrictions, which consumes a considerable amount of time. Also, those who do not have a license cannot operate a golf club business or recruit members even if he/she acquires a site area or a facility (Article 17). For this reason, a golf club business license in itself holds significant pecuniary value.

In the meantime, a golf club business entity may recruit members before completion of golf club construction, and invest the revenue therefrom in the said construction. The relevant business entity may draft and submit a membership recruitment plan, recruit additional members, and use the revenue therefrom even after the opening of the golf course and during its operation (Article 17). It is common for membership-based golf clubs to raise expenses for the construction and remodeling of a golf course through membership recruitment. As such, membership security deposits paid by the members are deemed to be embodied in the physical facility of a golf club.

B. Examination of the situation prior to the introduction of Article 27(2) of the Sports Facilities Act reveals that, at that time, even if a person acquired the physical facility of a golf club, including the site area and the clubhouse through a real estate auction, the license thereto did not naturally entail but rather remained with the former business entity. A winning bidder could not launch or operate the business upon its acquisition, because of the absence of a license. Hence, the winning bidder had to separately acquire the license, which had lost its physical foundation and remained only in form, from the former business entity for an inordinate amount of money. As a result, the bid price for the site area of a golf club decreased, incurring loss to the creditors and filling the pockets of the former business entity that no longer possessed the physical structure. Meanwhile, members of the golf club could not take advantage of their legal status and exercise the rights entailed by their membership once the golf club business entity changed, according to the legal principle that the relationship between the parties to a golf club usage agreement constitutes a claim-obligation relationship. Because the members of a membership-based golf club were not accorded legal protection upon the change of the business entity, despite having paid a considerable membership fee and thereby having shared the financial burden of a golf club's construction, this situation led to a serious social problem involving a large number of victims.

Article 27(2) of the Sports Facilities Act was introduced to address such problem, under which a person acquiring an essential sports facility to operate a sports facility such as a golf club naturally succeeds to (a) the license from the former business entity without a separate transfer process; as well as (b) the matters agreed upon between the former business entity and the members thereof. The introduction of the new provision (a) lifted the burden and expense of seeking the transfer of license from the former business entity and undertaking a separate approval procedure; and (b) ensured that a transferee succeeds to the obligations towards the existing members.

C. I examine Article 27 of the Sports Facilities Act in light of such legislative context.

Article 27(1) of the Sports Facilities Act is concerned with a case of the death, business transfer, and corporate merger of a sports facility business entity. The above mentioned cases represent legal requisites for comprehensive succession of rights and obligations. In such cases, the rights and obligations borne by the former sports facility business entity are transferred as they are to a successor, a transferee of business, and a merged corporate party (the remaining corporation or a new company). In the meantime, granting a license for the sports facility business is an *in rem* disposition, which is taken against a physical structure. As such, Parag. (1) confirms it as a theory that where the former business entity's rights and obligations including the physical foundation of a sports facility are naturally and comprehensively transferred under law, a transferee also succeeds to the license (i.e. a right under public law) and the matters agreed upon with the members (i.e. an obligation under private law) thereto.

As seen earlier in the legislative background, Parag. (2) was introduced to ensure: (a) succession of the rights and duties upon authorization and permission from the former business entity to the transferee, so that the transferee could continue the sports facility business without the need to take a separate licensing procedure, as in Parag. (1); and (b) succession of the matters agreed upon with the members of the facility, in a case where the transferee acquires a facility essential in launching and operating a sports facility business, even though said acquisition does not constitute the cases prescribed in Parag. (1) under which the rights and obligations under law are comprehensively transferred. The legal effect of these procedures was recognized, not because the procedures themselves were considered important, but because these procedures bring a change to the transferee of an essential sports facility, which, in general, serves as the physical foundation of a sports facility.

Article 27(2) of the Sports Facilities Act provides a list of procedures to which Parag. (1) may be applied *mutatis mutandis*, which runs as follows: "1. Auction pursuant to the Civil Execution Act; 2. Conversion pursuant to the Debtor Rehabilitation and Bankruptcy Act; 3. Sale of seized property pursuant to the National Tax Collection Act; the Customs Act, or the Local Tax Collection Act[.]" The said provision then provides for other procedures corresponding to subparagraphs 1 through 3 in Subparag. 4.

The procedures under Subparags.1 through 3 were stipulated not because of their legal commonalities but more of their function or effect. This is because the gist of Parag. (2) lies in ensuring natural succession of the license and the obligations towards members in cases of the transfer of an essential sports facility as does Parag. (1), not because an auction, realization, or public sale is similar in terms of legal nature to death, business transfer, or merger. Moreover, the presence of both similarities and differences among auction, realization, and public sale, stipulated under Subparags. 1 through 3, with respect to their purposes or processes renders it difficult to uniformly understand the nature of these procedures. Rather, auction, realization, and public sale under Subparags. 1 through 3 ought to be considered as having been enumerated as the representative cases of a compulsory realization procedure, whereby an essential sports facility is transferred against the wishes of a debtor, who is, in this case, the former sports facility business entity, for the recovery of a claim. Furthermore, it should be viewed that legislators introduced Subparag. 4 in order to include the realization process, wherein an essential sports facility may be transferred, that is not included in Subparags. 1 through 3, but which corresponds to the procedures stipulated under Subparags. 1 through 3.

Therefore, “other procedures corresponding to subparagraphs 1 through 3” in Subparag. 4 ought to be understood as the “realization process wherein a transfer of an essential sports facility takes place against the wishes of a debtor,” with a focus on the functional aspect of the relevant process. In this regard, the procedures under Subparag. 4 ought not to be understood in a limited sense, as referring to only those having legal and institutional commonalities with the each procedure enumerated under Subparags. 1 through 3, is unreasonable. Such an interpretation deviates from the fundamental intent of the framers of this provision.

D. Moving forward, examination of the instant security trust reveals the following. Creating a trust and establishing a mortgage to secure a claim are legally distinguishable. There are similarities and distinctions between an auction procedure based on a mortgage and public sale of trusted property under a security trust contract. Yet, both are not considerably different when viewed from the functional perspective of the procedures as the realization process. The two cannot be considered significantly distinct in light of their function and effect such as: (i) the identical purpose of securing a claim; (ii) the effect of bankruptcy remoteness and preferential payment right; (iii) the fact that realization process commences against the wishes of a debtor upon default in performance of obligations; (iv) the fact that both provide an essential sports facility, such as the site for golf course and clubhouse, as security; (v) the fact that a person acquiring the facility is determined in principle by competition after appraisal (a negotiated contract concluded after the failure of an auction may be considered as an extended public sale); and (vi) the fact that ownership of an essential sports facility of a golf club is transferred when the sale is completed. Therefore, there is no problem in viewing a public sale of trusted property as a procedure that corresponds to the procedures under Subparags. 1 through 3.

Article 27(2) of the Sports Facilities Act is intended to grant a benefit, i.e., natural succession of business license, to persons acquiring an essential facility of a sport facility, and, at the same time, ensure that they invariably succeed to the obligations towards its members, thereby protecting numerous members of the relevant facility. In this respect, Subparag. 4 ought to be interpreted in a manner that best lives up to such intent, and there is no need to make loopholes in membership protection by narrowly interpreting the pertinent provision.

For the foregoing reasons, I express my concurrence with the Majority Opinion.

Chief Justice	Kim Myeongsu (Presiding Justice)
Justices	Kim So-young
	Jo Hee-de
	Kwon Soon-il
	Park Sang-ok
	Lee Ki-taik
	Kim Jae-hyung (Justice in charge)
	Cho Jae-youn
	Park Jung-hwa
	Min You-sook
	Kim Seon-soo
	Lee Dong-won
	Noh Jeong-hee

Supreme Court Decision 2017Du33008 Decided November 15, 2018【Revocation of Disposition Imposing Corporate Tax】

【Main Issues and Holdings】

[1] Meaning of and standard for determining what constitutes "beneficial owner" as prescribed by Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Whether a tax treaty may be deemed inapplicable in the event that treaty abuse is acknowledged according to the principle of substantial taxation under the Framework Act on National Taxes even if constituting a beneficial owner of royalty income (affirmative)

[2] In a case where: (a) Company A concluded a license agreement with Hungary-based Company B regarding the domestic distribution of foreign exchange currencies, etc., but did not withhold corporate tax for royalties paid to Company B pursuant to Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; and (b) the competent taxing authority deemed Company C, the parent company of Company B that is based in the Netherlands, to be the *de facto* beneficial owner of royalty income by applying the Convention between the Government of the Republic of Korea and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and, subsequently, held Company A liable for withholding corporate tax, the Court holding that the application of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income cannot be denied with respect to royalty income even if based on the principle of substantial taxation under Article 14(1) of the Framework Act on National Taxes

【Summary of Decision】

[1] Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income stipulates, "Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that

other State if such resident is the beneficial owner of the royalties." Accordingly, even as to royalties constituting income earned from domestic sources under the Corporate Tax Act of Korea, the same cannot be taxable in Korea if said royalty is paid to a resident of Hungary who is the beneficial owner. In full view of the legislative history and context, etc. of the foregoing provision, a beneficial owner is a person who is entitled to enjoy benefits of the royalty income received and who is neither bound by law nor by contract to retransfer the relevant royalty income to another person. Determination of whether a person constitutes a beneficial owner as defined above should comprehensively factor the content and status of business activities related to the income at issue, the details of usage and operation of said income, etc.

Meanwhile, the principle of substantial taxation as prescribed in Article 14(1) of the Framework Act on National Taxes is likewise applicable to the interpretation and application of a tax treaty, which has the same effect as a statute, barring any special provision making exceptions. Therefore, in the event that treaty abuse is recognized according to the principle of substantial taxation under the Framework Act on National Taxes, the relevant tax treaty may be deemed inapplicable albeit constituting a beneficial owner of royalty income. That is, in case where (i) the person to whom a property nominally accrues lacks the capacity to control or manage property; (ii) there is another person who substantially controls or manages the property by means of governance, etc. over the nominal owner; and (iii) the disparity between name and substance arose out of the intent to avoid tax, the relevant tax treaty shall be inapplicable upon nominal ownership and the income pertaining to the property shall be deemed to accrue to the person who substantially controls or manages the property and, thus, said person shall be deemed liable for tax. However, if such disparity is nonexistent, the income is accrued to the nominal owner.

[2] In a case where: (a) Company A concluded a license agreement with Hungary-based Company B regarding the domestic distribution of foreign exchange currencies, etc., but did not withhold corporate tax for royalties paid to Company B pursuant to Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (hereinafter "Korea-Hungary Tax Treaty"); and (b) the competent taxing authority deemed Company C, the parent company of Company B that is based in the Netherlands, to be the *de facto* beneficial owner of royalty income by applying the Convention between the Government of the Republic of Korea and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and, subsequently, held Company A liable for withholding corporate tax, the Court determined that: (a) in full view of such circumstances as Company B's establishment history, details and status of

business activities, business performance with regard to the conclusion of contract with Company A, receipt of royalties therefrom, relevant expenses and use of funds, etc.; (b) Company B is deemed to have enjoyed benefits of the royalty income received without any legal or contractual obligation to transfer said income to Company C, etc.; (c) that said, Company B, as the resident of the Contracting State (Hungary) to said Treaty, constitutes a beneficial owner of royalty income under Article 12(1) of the Korea-Hungary Tax Treaty; (d) furthermore, when comprehensively considering the business history in Hungary of the pertinent global group to which Company B is affiliated with, Company B's business divisions and long-term business activities, human and physical resources, details on the control, management, and disposition of distribution right and royalty income, etc.; (e) it is reasonable to deem that Company B, as an ordinary media business entity of substantial form that operates in Hungary based on a clear business purpose, *de facto* controlled and managed the nominal distribution right and the royalty income incurred therefrom, just like other assets owned; (f) as such, the applicability of the Korea-Hungary Tax Treaty cannot be denied with respect to royalty income even if based on the principle of substantial taxation under Article 14(1) of the Framework Act on National Taxes; (g) nevertheless, the lower court held that the taxing authority's disposition as above was lawful by deeming Company C to be the beneficial owner of royalty income solely from a tax saving perspective; and (h) in so doing, the lower court erred by misapprehending the legal doctrine.

【Reference Provisions】 [1] Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; Article 14(1) of the Framework Act on National Taxes; Articles 93 and 98(1) of the Corporate Tax Act / [2] Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; Article 12 of the Convention between the Government of the Republic of Korea and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; Article 14(1) of the Framework Act on National Taxes; Articles 93 and 98(1) of the Corporate Tax Act

Article 12 of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Royalties)

(1) Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties.

Article 12 of the Convention between the Government of the Republic of Korea and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Royalties)

1. Royalties arising in one of the States and paid to a resident of the other State may be taxed in that other State.

2. However, such royalties may be taxed in the State in which they arise, and according to the law of that State, but the tax so charged shall not exceed:

(a) 15 percent of the gross amount in the case of royalties as defined in paragraph 3, subparagraph a); and

(b) 10 percent of the gross amount in the case of royalties as defined in paragraph 3, subparagraph b).

3. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use:

(a) any copyright of literary, artistic or scientific work including cinematography films; and

(b) any patent, trademark, design or model, plan, secret formula or process, industrial, commercial or scientific equipment; or information concerning industrial, commercial or scientific experience.

4. The provisions of paragraphs 1 and 2 shall not apply if the recipient of the royalties, being a resident of one of the States, has in the other State in which the royalties arise a permanent establishment with which the right or property giving rise to the royalties is effectively connected. In such a case, the provisions of Article 7 shall apply.

5. Royalties shall be deemed to arise in one of the States when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties whether he is a resident of one of the States or not, has in one of the States a permanent establishment in connection with which the contract under which the royalties are paid was concluded, and such royalties are borne by such permanent establishment, then such royalties shall be deemed to arise in the State in which the permanent establishment is situated.

6. Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according

to the law of each State, due regard being had to the other provisions of this Convention.

Article 14 of the Framework Act on National Taxes (Actual Taxation)

(1) If any ownership of an income, profit, property, act or transaction which is subject to taxation, is just nominal, and there is other person to whom such income, etc., belongs, the other person shall be liable to pay taxes and tax-related Acts shall apply, accordingly.

Article 93 of the Corporate Tax Act (Domestic Source Income of Foreign Corporations)

Domestic source income of a foreign corporation shall be classified as follows: *<Amended by Act No. 11128, Dec. 31, 2011; Act No. 13555, Dec. 15, 2015; Act No. 14386, Dec. 20, 2016>*

1. The following income, which includes interest income referred to in Article 16(1) of the Income Tax Act (excluding the income provided for in subparagraph 7 of the same paragraph), other interest on loans and profits from trusts: *Provided*, That the same shall not apply to interest on any loan directly obtained by an overseas place of business for the overseas place of business of a resident or domestic corporation:

(a) Income received as a payment from the State, a local government, a domestic place of business of a resident, domestic corporation or foreign corporation, or a domestic place of business of a non-resident referred to in Article 120 of the Income Tax Act;

(b) Income received as a payment from a foreign corporation or non-resident, which is substantially related to the domestic place of business of the foreign corporation or non-resident and is included in deductible expenses or incurred expenses for the purpose of calculating the amount of income of such domestic place of business;

2. Dividend income provided for in Article 17(1) of the Income Tax Act (excluding the income provided for in subparagraph 6 of the same paragraph) that is paid in the Republic of Korea by any domestic corporation, any organization deemed a corporation, or any other domestic source and the amount disposed of as a dividend under Articles 9 and 14 of the Adjustment of International Taxes Act;

3. Income accrued from real estate in the Republic of Korea or real estate rights and mining rights, mining concessions or rights to quarry earth, sand, and rocks, each of which is acquired in the Republic of Korea, or the transfer or lease of rights to use or develop underground water or other management of underground water: *Provided*, That excluded herefrom shall be capital gains referred to in subparagraph 7;

4. Income accrued from the rental of a ship, aircraft, registered motor vehicles, construction machinery, industrial, commercial or scientific machinery, facilities and equipment, and other tools prescribed by Presidential Decree to a domestic place of business of a resident,

domestic corporation or foreign corporation, or a domestic place of business of a non-resident referred to in Article 120 of the Income Tax Act;

5. Income prescribed by Presidential Decree and accrued from any business operated by a foreign corporation (including income taxable as domestic source business income under any tax treaty): *Provided*, That excluded herefrom shall be income referred to in subparagraph 6;

6. Income accrued by rendering personal services prescribed by Presidential Decree in the Republic of Korea (including the income deemed to have accrued in the Republic of Korea according to a tax treaty by rendering personal services prescribed by Presidential Decree, among personal services rendered abroad). In such cases, where the person provided with the person al services bears expenses prescribed by Presidential Decree, including airfares, in connection with the provision of such personal services, such income means an amount excluding such expenses;

7. Capital gains on a transfer of any of the following assets or rights: *Provided*, That this shall be limited where the assets or rights which generate such gains are in the Republic of Korea:

(a) Assets or rights referred to in Article 94(1)1, 2, and 4(a) and (b) of the Income Tax Act;

(b) Stocks, etc. (referred to as "real estate, stocks, etc." hereafter in this Article) of a domestic corporation, where the aggregated of the following values is at least 50/100 of total assets of that domestic corporation as at the start date of the business year in which the relevant assets are transferred, among stocks, etc. (including depository receipts or preemptive rights issued on the basis of stocks, etc.; the same shall apply hereafter in this Chapter) of such domestic corporation, which have not been listed on any securities market under the Financial Investment Services and Capital Markets Act;

(i) The value of assets referred to in Article 94(1)1 and 2 of the Income Tax Act;

(ii) The value calculated by multiplying the value of stocks of another corporation that excessively owns real estate, which is owned by the domestic corporation, by the ratio of real estate owned by that corporation. In such cases, the methods for determining a corporation that excessively owns real estate and for determining the ratio of ownership of real estate shall be prescribed by Presidential Decree.

8. Where any of the following rights, assets, or information (referred to as "rights, etc." hereafter in this subparagraph) are used or the remuneration therefor is paid in the Republic of Korea, the relevant price and the income accrued from the transfer of such rights, etc.:

Provided, That where the place of use rule applies, under an agreement for preventing double taxation on income, to determine whether the relevant income is domestic source income, the remuneration for rights, etc., used overseas shall not be deemed domestic source income, regardless of whether it was paid in the Republic of Korea. In such cases, rights requiring registration to exercise thereof, such as patent rights, utility model rights, trademark rights, and design rights (referred to as "patent rights, etc." hereafter in this subparagraph) shall be deemed used in the Republic of Korea, irrespective of whether they were registered in the Republic of Korea, if the relevant patent rights, etc., were registered overseas and have been used for manufacture, sale, etc., in the Republic of Korea:

(a) Copyrights, patent rights, trademark rights, designs, forms, and sketches of academic or artistic works (including movie films) or secret formulae or processes, film and tapes for radio and television broadcast, and other similar assets or rights;

(b) Information or know-how related to industrial, commercial, or scientific knowledge and experience;

9. Income prescribed by Presidential Decree and accrued from the transfer of any of the following stocks, etc. (including real estate stocks, etc., listed on any securities market under the Financial Investment Services and Capital Markets Act), or other securities (including securities defined in Article 4 of the Financial Investment Services and Capital Markets Act; hereinafter the same shall apply):

(a) Stocks, etc., and other securities issued by a domestic corporation;

(b) Stocks, etc., issued by a foreign corporation (limited to stocks, etc., listed on any securities market under the Financial investment Services and Capital Markets Act), and other securities issued by a domestic place of business of a foreign corporation;

10. Any of the following, other than those provided for in subparagraphs 1 through 9:

(a) Insurance money, indemnification, or compensation paid in connection with any real property or other assets situated in the Republic of Korea, or business run in the Republic of Korea;

(b) Income prescribed by Presidential Decree as penalties for breach of any contract or compensation for damage paid in the Republic of Korea;

(c) Income accrued from the inheritance of domestic assets;

(d) Prize money, monetary rewards, compensation, and other similar income paid in the Republic of Korea;

(e) Income accrued from buried property discovered in the Republic of Korea;

(f) Income accrued from the transfer of licenses, approval, or rights established by other similar administrative dispositions under laws of the Republic of Korea, and from the transfer of domestic assets, other than real estate;

(g) Prize received based on lottery, gift tickets, or other drawing tickets, and refunds paid to the purchasers of horse-race tickets, winner-betting tickets, bullfighting tickets, or sports promotion tickets, all issued in the Republic of Korea;

(h) Amounts disposed of as other income pursuant to Article 67;

(i) Income accruing from an increase in the value of the stocks, etc. of a domestic corporation that are held by any related party prescribed by Presidential Decree (referred to as "foreign related party" hereafter in Article 98) that arises from capital transactions prescribed by Presidential Decree;

(j) Income from any business operated in the Republic of Korea, from personal services rendered in the Republic of Korea, or from economic benefits received in relation to assets located in the Republic of Korea (excluding the difference, if any, between the amount received for redemption of foreign currency-denominated bonds issued by the State or financial companies, etc., established under any special Act and the issue prices of such bonds) or other similar income prescribed by Presidential Decree, other than those referred to in any of items (a) through (i).

[This Article wholly amended by Act No. 10423, Dec. 30, 2010]

Article 98 of the Corporate Tax Act (Special Cases concerning Withholding or Collection from Foreign Corporations)

(1) Where any person pays a foreign corporation the amount of domestic source income provided for in subparagraphs 1, 2, and 4 through 10 of Article 93 (excluding any resident or non-resident who pays the amount of income provided for in subparagraph 7 of Article 93) which is not substantially related to the domestic place of business of the foreign corporation or does not revert to the domestic place of business of the foreign corporation (including an amount paid to a foreign corporation with no domestic place of business), he/she shall withhold, as the corporate tax, the following amounts from the income of the relevant foreign corporation for each business year, and pay it at the tax office having jurisdiction over the place of tax payment, etc., as prescribed by Presidential Decree, by the tenth day of the month following the month in which the date of withholding falls, notwithstanding Article 97: *Provided*, That the same shall not apply to income provided for in subparagraph 5 of Article 93, which is taxable as domestic source business income under the applicable tax treaty: <*Amended by Act No. 11607, Jan. 1, 2013; Act No. 14386, Dec. 20, 2016*>

1. Income referred to in subparagraphs 4 and 5 of Article 93: 2/100 of the amount paid;

2. Income referred to in subparagraph 6 of Article 93: 20/100 of the amount paid: *Provided*, That the rate shall be 3/100 of the amount paid in cases of income accrued by rendering personal services prescribed by Presidential Decree, out of personal services rendered abroad, but that shall be deemed accrued in the Republic of Korea under a tax treaty;

3. Income referred to in subparagraphs 1, 2, 8, and 10 of Article 93: 20/100 of the amount paid (the amount prescribed by Presidential Decree in cases of the income specified in subparagraph 10(c) of Article 93): *Provided*, That it shall be 14/100 of the amount paid in cases of the interest income accrued from bonds issued by the State, a local government, or a domestic corporation among the income specified in subparagraph 1 of Article 93;

4. Income referred to in subparagraph 7 of Article 93: 10/100 of the amount paid: *Provided*, That if the acquisition value and transfer expenses of the assets transferred are verified, an amount equivalent to 10/100 of the amount paid or an amount equivalent to 20/100 of capital gains on a transfer of such assets, whichever is smaller;

5. Income referred to in subparagraph 9 of Article 93: 10/100 of the amount paid (referring to “arm’s length price” provided for in Article 92(2)2 in cases falling under the same subparagraph; hereafter referred to as “amount paid, etc.” in this subparagraph): *Provided*, That if the acquisition value and transfer expenses of the relevant securities are verified under the proviso to Article 92(2)1, an amount equivalent to 10/100 of the amount paid, etc., or an amount equivalent to 20/100 of the amount calculated under the proviso to the same subparagraph, whichever is smaller.

【Reference Cases】 [1] Supreme Court Decisions 2010Du11948 decided Apr. 26, 2012 (Gong2012Sang, 892); 2010Du20966 decided Jul. 11, 2013; 2015Du2451 decided Jul. 14, 2016 (Gong2016Ha, 1195); 2015Du55134, 55141 decided Jul. 11, 2017 (Gong2017Ha, 1663); 2017Du59253 decided Dec. 28, 2017 (Gong2018Sang, 449)

【Plaintiff-Appellant】 CJ E&M Co., Ltd. (Attorneys Kim Eui-hwan et al., Counsel for the plaintiff-appellant)

【Defendant-Appellee】 Head of National Tax Service Mapo District Office (Gaon Law, Attorneys Kang Nam-gyu et al., Counsel for the defendant-appellee)

【Judgment of the court below】 Seoul High Court Decision 2016Nu55089 decided December 13, 2016

【**Disposition**】 The lower judgment is reversed, and the case is remanded to the Seoul High Court.

【**Reasoning**】 The grounds of appeal are examined.

1. Case summary and key issue

A. Case summary

(1) On May 31, 2011, the Plaintiff concluded a license agreement relating to the domestic distribution of Paramount films, etc. with Hungary-based entity Viacom International Hungary Kft (hereinafter "VIH"), which is affiliated with the global entertainment content group Viacom that owns the film producing company Paramount and music channel MTV. From around that time to December 2013, the Plaintiff paid VIH royalties amounting to roughly KRW 13.5 billion (hereinafter "pertinent royalty income").

(2) The Plaintiff did not withhold the corporate tax regarding the pertinent royalty income according to Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (hereinafter "Korea-Hungary Tax Treaty").

(3) However, the Defendant: (a) deemed that VIH was merely a conduit company established for the purpose of tax avoidance and that the *de facto* beneficial owner of the pertinent royalty income was Viacom Global Netherlands BV (hereinafter "VGN"), the parent company of VIH based in the Netherlands; (b) applied the Convention between the Government of the Republic of Korea and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (hereinafter "Korea-Netherlands Tax Treaty"), rather than the Korea-Hungary Tax Treaty; and (c) imposed the corporate tax withheld totaling KRW 2,391 million (including penalty tax) against the Plaintiff on May 2, 2014 and July 1, 2014, respectively (hereinafter "instant disposition").

B. Key issue

The key issue of this case is whether Article 12(1) of the Korea-Hungary Tax Treaty is applicable with respect to the pertinent royalty income.

2. Ground of appeal No. 1

A. (1) <u>Article 12(1) of the Convention between the Government of the Republic of Korea and the Government of the Hungarian People's Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income stipulates, "Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties." Accordingly, even as to royalties constituting income earned from domestic sources under the Corporate Tax Act of Korea, the same cannot be taxable in Korea if said royalty is paid to a resident of Hungary who is the beneficial owner. In full view</u>

of the legislative history and context, etc. of the foregoing provision, a beneficial owner is a person who is entitled to enjoy benefits of the royalty income received and who is neither bound by law nor by contract to retransfer the relevant royalty income to another person. Determination of whether a person constitutes a beneficial owner as defined above should comprehensively factor the content and status of business activities related to the income at issue, the details of usage and operation of said income, etc.

(2) Meanwhile, the principle of substantial taxation as prescribed in Article 14(1) of the Framework Act on National Taxes is likewise applicable to the interpretation and application of a tax treaty, which has the same effect as a statute, barring any special provision making exceptions (*see*, *e.g.*, Supreme Court Decision 2010Du11948, Apr. 26, 2012). Therefore, in the event that treaty abuse is recognized according to the principle of substantial taxation under the Framework Act on National Taxes, the relevant tax treaty may be deemed inapplicable albeit constituting a beneficial owner of royalty income. That is, in case where (i) the person to whom a property nominally accrues lacks the capacity to control or manage property; (ii) there is another person who substantially controls or manages the property by means of governance, etc. over the nominal owner; and (iii) the disparity between name and substance arose out of the intent to avoid tax, the relevant tax treaty shall be inapplicable upon nominal ownership and the income pertaining to the property shall be deemed to accrue to the person who substantially controls or manages the property and, thus, said person shall be deemed liable for tax. However, if such disparity is nonexistent, the income is accrued to the nominal owner (*see*, *e.g.*, Supreme Court Decision 2015Du2451, Jul. 14, 2016).

B. The reasoning of the lower judgment and the record reveals the following.

(1) For over ten years prior to the establishment of VIH, Viacom Group has engaged in the broadcasting channel business in Hungary. Around 2010, during the Group's restructuring, Viacom separately established VIH in consideration of Hungary's talented workforce, relatively affordable lease fee, the Hungarian government's investment incentive, etc. as well as Hungary's broadcasting law proscribing a domestic broadcasting channel operator from simultaneously engaging in a foreign broadcasting channel and foreign distribution business. Thereafter, VIH actively carried out businesses relating to the distribution of films (produced by Paramount), global business service (GBS), and Central & Eastern Europe media network (VIMN-CEE).

(2) In Korea as well as other countries, such as Hungary, Japan, Italy, Israel, and Spain, VIH has been distributing Paramount-produced films and receiving royalties therefrom. According to Hungarian law, VIH paid the due corporate tax and underwent an external audit of its financial statement. Viacom Group's global effective tax rate is roughly 30% to 32%.

(3) VIH posted net sales of roughly KRW 214.8 billion in 2011, roughly KRW 440.2 billion in 2012, and KRW 303.5 billion in 2013. It recruited 19 people for its film distribution business division located in Budapest and has spent approximately KRW 6.6 billion in personnel expense over three years.

(4) Operating a separate film distribution business division, VIH performed such tasks as recruitment, office and space expansion, conclusion of a license agreement on distribution right, and introduction of a debt management system. Any major decisions were made by holding a board of directors meeting in Hungary. VIH's management has no relation with VGN and its workforce does not overlap with the same.

(5) Matters related to the license agreement between VIH and VGN were discussed in detail at the VIH's board of directors meeting. VIH's legal team handled contractual matters (i.e., contract delivery, affirmation, and conclusion) including the review of the contract between the Plaintiff and VIH, and other employees of VIH directly performed duties related to the distribution of films to the Plaintiff (i.e., agreement on film content, image quality, sound quality, and subtitles) as well as the receipt and management of royalties.

(6) Of the net sales amounting to roughly KRW 922.4 billion from 2011 to 2013, VIH used roughly KRW 233.5 billion in business activity-related expenses such as personnel expense and COGS (e.g., ad costs, printing costs, operating costs, and other contractual costs). Dividends paid out to shareholders amounted to roughly KRW 388.7 billion (approximately 42% of the total) and the remaining funds were extended as loans to Viacom Overseas Holdings CV (affiliate) and interests (Budapest Interbank Offered Rate (BIOR) + 0.625%) were collected therefrom.

(7) Subsequently, VIH continued to expand its business by proactively investing in broadcasting and film-related businesses in Romania and Israel. As of January 2016, VIH's workforce by division is as follows: film distribution (26), GBS (102), and VIMN-CEE (80).

C. The above factual basis is examined in light of the legal doctrine as seen earlier.

(1) First, we examine whether VIH constitutes a beneficial owner of royalty income under Article 12(1) of the Korea-Hungary Tax Treaty.

Fully viewing the following circumstances — VIH's establishment history and business activities, details on the performance of activities related to the agreement with the Plaintiff and the receipt of royalties therefrom, and details of relevant expenses and operation of funds — VIH is deemed to have enjoyed benefits of the royalty income received without any legal or contractual obligation to transfer said income to VGN, etc. Accordingly, as the resident of the Korea-Hungary Tax Treaty, there is sufficient room to regard that VIH constitutes a beneficial owner of royalty income under Article 12(1) thereof.

(2) Next, we examine whether the Korea-Hungary Tax Treaty is inapplicable with respect to the pertinent royalty income based on the principle of substantial taxation under the Framework Act on National Taxes.

When comprehensively considering Viacom Group's business history in Hungary; VIH's business divisions and long-term business activities; human and physical resources; and details on the control, management, and disposition of distribution right and royalty income, etc., it is reasonable to deem that VIH, as an ordinary media business entity of substantial form that operates in Hungary based on a clear business purpose, *de facto* controlled and managed the nominal distribution right and the royalty income incurred therefrom, just like other assets owned. Solely on the basis that (i) VIH paid a considerable portion of profit available for dividends to VGN (100% parent company based in the Netherlands), and (ii) most counterpart countries of the film distribution right that VGN granted to VIH upon establishment are signatories of the Korea-Hungary Tax Treaty and, thus, not subject to source taxation with respect to royalty income, deeming that VIH was incapable of controlling and managing the distribution right or that disparity existed between the name and the substance of the pertinent royalty income is difficult.

Insofar as VIH is deemed to have *de facto* nominal ownership of the pertinent royalty income paid by the Plaintiff given that no disparity exists between the name and the substance of the reverted income, the applicability of the Korea-Hungary Tax Treaty cannot be denied with regard to the royalty income even if based on the principle of substantial taxation under Article 14(1) of the Framework Act on National Taxes.

D. Nevertheless, the lower court determined that the instant disposition was lawful by deeming that VGN was the beneficial owner of the royalty income in question solely from a tax saving standpoint as stated in its holding. In so doing, the lower court erred and adversely affected the conclusion of the judgment by misapprehending the meaning of beneficial owner under Article 12(1) of the Korea-Hungary Tax Treaty, the principle of substantial taxation under Article 14 of the Framework Act on National Taxes, and the determination of the beneficial owner thereof. The allegation contained in the grounds of appeal on this point is with merit.

3. Conclusion

Therefore, without proceeding to decide on the remaining grounds of appeal, the lower judgment is reversed, and the case is remanded to the lower court for further proceedings consistent with this Opinion. It is so decided as per Disposition by the assent of all participating Justices on the bench.

Justices Jo Hee-de (Presiding Justice)
Kim Jae-hyung
Min You-sook (Justice in charge)
Lee Dong-won