

Legal Updates

Stocks as Security in PF Loans

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PF loans are a commonly used method for financing real estate development projects in Korea. PF loans present a greater risk to lenders than general real estate mortgage loans, as PF loans are executed at the start of the real estate development process. The primary consideration for granting a PF loan is a project's projected cash flow, and in order to prevent contingent liabilities of the borrower or developer and to regulate the borrower or developer, it has been a customary practice to establish a pledge over or transfer of the ownership right of the issued shares (or contributed shares) of the borrower or developer.

But in order to pledge or transfer the ownership of the issued shares (or contributed shares) of the borrower or developer, various restrictions from the Banking Act, Insurance Business Act and Financial Investment Services and Capital Markets Act ("FISCMA") apply and need to be considered. The current practice in the industry and legal landscape indicate that unlike before such restrictions are easing up. For example, the old Banking Act prohibited financial institutions including banks from directly or indirectly taking security interest on more than 20% of the issued shares as collateral for a loan. But the amended Banking Act, which was enacted on May 17, 2010, allows for banks to make a loan using the shares issued by another company as collateral, so long as this is reported to the relevant government authority afterward.

Another way for a financial institution to make a PF loan is through a trust. Because of the independence and bankruptcy remote impact of trusts, it has the advantage of being more stable form of security than general pledge or transfer of ownership right. The recently amended Trust Act, in particular, makes possible diverse use of trusts to obtain security interest in stocks.

However, the Act on the Structural Improvement of the Financial Industry (“ASIFI”) requires a financial institution to get an approval from the Financial Services Commission before a financial institution acquires more than 20 percent of voting shares issued by a company. (See Article 24.1.1, ASIFI) Should it be deemed that this requirement applies to the financial institution trustee who owns (acquires) the issued shares of a borrower or developer as collateral for a PF loan, it would not be feasible for the financial institution to be in possession of more than 20% of the issued shares. And this would in effect eliminate the diverse means available to use shares issued by the borrower or developer as collateral under the amended Trust Act.

Along the same lines as ASIFI’s restriction, the Banking Act and Insurance Business Act limit a bank’s or insurer’s investment in a company to 15%. But given the distinct nature of trusts it is generally interpreted that such limitation does not apply to the shares acquired in the operation of trusts. Also, if a financial institution acquires shares issued by another company through a trust, FISCMA comes into play. In this way, the financial institution would only be able to exercise its voting rights for up to 15% of the shares issued by the company, or would proceed in a way, namely shadow voting, so as not to affect the decision-making process for the company. The Trust Act and other relevant laws already have a protection measure to make sure that a financial institution does not influence the management and operation of a company whose shares it acquires for security purposes and that it does not limit financial prospects of the company.

Making it possible for financial institutions to acquire shares for collateral through trusts for PF loans goes beyond just promoting stability in collateral acquisition and preventing loan defaults. It can further contribute to the stability in the financial markets generally. So in addition to pledges and transfer of ownership rights, trusts and other means need to be considered for maximizing the benefits of using stock as collateral for PF loans. And for this to happen, ASIFI and other laws must be approached in a more forward-looking manner.