

CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37

BEFORE THE
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES

LSF-KEB Holdings SCA
LSF SLF Holdings SCA
HL Holdings SCA
Kukdong Holdings I SCA
Kukdong Holdings II SCA
Star Holdings SCA
Lone Star Capital Management SPRL
Lone Star Capital Investments S.à.r.l.
Claimants,

v.

Republic of Korea
Respondent.

Case No. ARB/12/37

CLAIMANTS' MEMORIAL ON THE MERITS

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TABLE OF CONTENTS

	Page
I. EXECUTIVE SUMMARY	1
II. INTRODUCTION.....	15
III. STATEMENT OF FACTS.....	15
A. THE ORIGINS OF KEB’S FINANCIAL DIFFICULTIES	16
1. Korea’s Economic Model Leads to Economic Meltdown	18
2. Korea Responds to the Economic Crisis by, Among Other Things, Taking Measures to Stimulate Foreign Investment.....	22
a. Rescuing the Financial Sector.....	22
b. Regulatory Reforms	24
(i) <i>Opening Capital Markets and Attracting Foreign Investors.</i> 24	
(ii) <i>Reining in the Chaebol.</i>	25
(iii) <i>Financial Supervision</i>	26
3. Resentment Against Foreign Investment Builds in Korea’s Post-Crisis Political Culture	27
4. On the Verge of Insolvency, Korea Exchange Bank Seeks an Injection of Foreign Capital	29
a. KEB During the 1997 Crisis.....	30
b. KEB Tries to Shore Up Its Capital Position	33
B. LONE STAR RESCUES KEB	36
1. Lone Star’s Successful History in East Asia.....	37
2. Lone Star Agrees to Invest More Than \$1 Billion in KEB	39
3. The Korean Government Grants Regulatory Approval of Lone Star’s Acquisition to Ensure that KEB Remains Solvent.....	42
4. KEB Immediately Regains Its Financial Footing as a Result of Lone Star’s Investment	46

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

C.	TO LONE STAR’S SURPRISE, THE KOREAN GOVERNMENT DEMANDS THAT KEB CHANNEL MUCH OF LONE STAR’S EQUITY INJECTION TO RESCUE KEB CARD ...	47
D.	KEB’S REMARKABLE TURNAROUND AFTER LONE STAR’S INVESTMENT	50
	1. KEB’s New Management Takes Immediate Steps to Improve KEB’s Financial Performance	51
	a. KEB Improves Its Capital Adequacy Ratio	51
	b. KEB Improves Asset Quality and Risk Management.....	53
	2. KEB’s New Management Makes Organizational and Structural Improvements.....	55
	3. Within Two Years, KEB’s Profitability Reaches Record Levels and Outperforms Competing Korean Banks.....	57
	4. The Korean Government Continues to Interfere in the Operation of KEB and Hinders Reform.....	58
E.	FROM SAVIOR TO VILLAIN: NATIONALISM, SCANDAL-MONGERING, AND ACTIVIST GROUPS TURN LONE STAR INTO A PUBLIC ENEMY	60
	1. Bank Sales by Newbridge and Carlyle Provoke Anti-Foreign Sentiment	62
	2. High-Profile Tax Raids Inflamm Public Sentiment	64
	3. Steven Lee’s Embezzlement from Lone Star.....	67
	4. Spec Watch, Activist Groups, and the Media See an Opportunity to Create a Scandal	69
	a. Spec Watch Korea Launches a Public Campaign, as Its Leader Threatens to “Get Even” with Lone Star	69
	b. The Media Rails Against “Foreign Speculative Capital,” Further Provoking Anti-Lone Star Sentiment.....	72
	5. Labor Unions Join the Attacks on Lone Star	73
F.	PARTISAN POLITICS AND POLITICAL OPPORTUNISM LEAD THE NATIONAL ASSEMBLY AND GOVERNMENT AGENCIES TO TARGET LONE STAR.....	74
	1. The “Lone Star Sniper” and Other Political Opportunists in the National Assembly Attack Lone Star	75

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

a.	Politicians Use the Lone Star Controversy to Raise Their Political Profile.....	77
b.	Opposition Parties Use Lone Star to Attack the Roh Administration	79
c.	The National Assembly Takes Official Action to Further the Lone Star Investigation	82
2.	LSF-KEB’s Ill-Fated Agreement to Sell KEB to Kookmin	84
3.	Investigatory Agencies Engage in a Campaign of Harassment	87
a.	The Board of Audit and Inspection.....	89
b.	The Supreme Prosecutor’s Office	90
(i)	<i>Allegations of Wrongdoing Relating to the KEB Acquisition</i>	91
(ii)	<i>Allegations of Stock Price Manipulation Relating to KEB Card Merger</i>	<i>93</i>
G.	AS A PRECAUTIONARY MEASURE, LONE STAR SELLS A BLOCK OF ITS KEB STOCK.....	94
H.	FINANCIAL REGULATORS ARE PARALYZED BY THE FEAR OF PUBLIC AND POLITICAL BLOWBACK AND SEEK TO AVOID THEIR LEGAL OBLIGATIONS IN REVIEWING APPLICATIONS FROM WOULD-BE PURCHASERS OF LONE STAR’S INVESTMENT	95
1.	The Banking Act and the Scope of the FSC’s Review	96
a.	The Banking Act Requires that the FSC Review Applications for Regulatory Approval Based on the Applicant, Not the Seller	96
b.	Allegations Regarding Lone Star’s Alleged Improprieties with Respect to Its Acquisition of KEB Were Irrelevant to the FSC’s Decision Whether to Approve HSBC’s Acquisition of the Shares....	98
c.	Korean Law Is in Line with International Best Practices that Call for a Review of the Acquirer, not the Seller, when Regulators Review Applications to Acquire a Bank.....	100
2.	The Banking Act Imposes Strict Deadlines for the FSC to Decide on an Application to Acquire a Bank.....	101
3.	The FSC Had Publicly Acknowledged the Limits of Its Authority to Review Applications to Acquire a Bank, But Cast Those Limitations	

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

	Aside When It Came Time to Review HSBC's and Hana's Applications	103
I.	THE POTENTIAL SALE TO HSBC COLLAPSES DUE TO THE FSC'S REFUSAL TO MAKE A DECISION ON HSBC'S APPLICATION FOR REGULATORY APPROVAL	107
1.	The Chronology of HSBC's Failed Attempt to Acquire Lone Star's Stake in KEB Due to Regulators' Paralysis	108
a.	August 2007 – January 2008: HSBC and LSF-KEB Enter into a Sale Agreement But the FSC Immediately Announces that It Cannot Make a Decision to Approve the Deal Due to Unrelated Legal Proceedings.....	108
b.	January 2008 – February 2008: The FSC Continues to Refuse to Act on HSBC's Application Due to Unrelated Legal Proceedings .	112
c.	March 2008 – April 2008: A Glimmer of Hope, Later Dashed, that the FSC Will Approve HSBC's Application	113
d.	May 2008 – September 2008: The Deal Collapses as External Political and Legal Events Prompt the FSC to State that "Public Sentiment" Must Be Taken into Account in Assessing HSBC's Application.....	115
e.	Post-Termination Developments: The FSC's Arbitrary Re-Opening of Lone Star's Qualifications to Be a Major Shareholder of KEB	120
2.	The FSC Violated Korean Law in Refusing to Act on HSBC's Application.....	122
a.	The FSC Exceeded the Time Periods Required by Law for Reviewing HSBC's Application.....	123
b.	The FSC Improperly Failed to Make a Decision Based on HSBC's Qualifications and Instead Focused on Lone Star.....	124
J.	LONE STAR SELLS ITS KEB SHARES TO HANA FINANCIAL GROUP, BUT ONLY AFTER EXTENDED DELAY DUE TO THE REGULATORS' PARALYSIS AND ONLY AFTER THE REGULATORS FORCE A PRICE REDUCTION.....	126
1.	November 2010: Hana Finally Succeeds in Bidding for KEB	128
a.	LSF-KEB and Hana Enter into a SPA	128
b.	Hana Applies for Regulatory Approval under The Financial Holding Companies Act.....	129

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

2.	March 2011: On the Eve of FSC Approval, the Supreme Court Vacates Paul Yoo’s Acquittal, Giving the FSC Another Excuse for Delaying Action on Hana’s Application.....	130
3.	July 2011: The SPA Is Extended Until November 2011 in the Hope that Regulatory Approval Might Be Forthcoming	136
4.	October 2011: The FSC Orders LSF-KEB to Sell Its Shares But Still Does Not Approve Hana’s Application	139
a.	The FSC Strips LSF-KEB of Its Voting Rights and Orders Disposal of Its Shares.....	139
b.	The FSC Pushes Hana to Renegotiate the SPA and Submit a New Application with a Lowered Price	143
c.	The FSC Continues Its Campaign Against Lone Star But Finally Approves Hana’s Application.....	153
d.	After Hana’s Application Is Approved, Further FSC-Imposed Conditions on the Closing Come to Light	156
K.	HARASSMENT OF LONE STAR PERSISTS EVEN AFTER IT EXITS KOREA	158
1.	Activist Groups File Additional Lawsuits Against Lone Star	158
2.	The Korean Courts Refuse to Enforce an ICC Arbitral Award Issued in Lone Star’s Favor	159
L.	ARBITRARY ENFORCEMENT BY THE KOREAN TAX AUTHORITIES IN RESPONSE TO POLITICAL OPPOSITION TO LONE STAR	161
1.	Korea’s Politically-Motivated Campaign to Impose Arbitrary and Abusive Taxes on Lone Star and Other Foreign Private Equity Funds	164
2.	Introduction to the Fundamental Principles of International Tax Law Relevant to This Arbitration.....	174
a.	Categories of Income	175
b.	Bilateral Tax Treaties.....	176
c.	Permanent Establishment.....	179
d.	Withholding Tax	180
3.	Overview of Lone Star’s Investment Structure	182
4.	Basic Features of the Four NTS Tax Assessments at Issue.....	185

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

a.	The 2004 STC Sale	185
b.	The 2007 Sale of Shares in KEB, Kukdong, and Star Lease and Related Dividends from 2004-2007	188
c.	The 2012 Sale of the Remaining Shares in KEB	191
d.	The 2008-2011 KEB Dividends.....	193
5.	The NTS’s Targeting of Claimants for Arbitrary and Punitive Tax Assessments	195
a.	The NTS Unlawfully and Incorrectly Disregarded the Belgian Claimants as the Owners of Lone Star’s Investment Income	195
b.	After Avoiding the Korea-Belgium Tax Treaty, the NTS Advanced Its Goal of Maximum Tax by Misinterpreting the Other Tax Treaties Applicable to the Ultimate Investors	207
c.	The NTS Changes Course and Assesses Tax Under an Unprecedented PE Theory	211
6.	Taken as a Whole, the NTS’s Targeted Tax Treatment Was Inconsistent, Contradictory, Arbitrary, and Discriminatory	216
IV.	THE TRIBUNAL HAS JURISDICTION OVER THIS DISPUTE	220
A.	CLAIMANTS ARE INVESTORS PROTECTED BY THE BIT AND NATIONALS OF CONTRACTING STATES OTHER THAN THE STATE PARTY TO THE DISPUTE UNDER THE ICSID CONVENTION	222
1.	Claimants Are Investors Protected by the BIT	222
2.	Claimants Are Nationals of Contracting States Other than the State Party to the Dispute Under the ICSID Convention	223
B.	CLAIMANTS’ INVESTMENTS ARE COVERED BY THE BIT AND THE ICSID CONVENTION	224
1.	Claimants’ Investments Are Covered by the BIT.....	225
a.	LSF-KEB Holdings SCA’s Investments in Korea Are Protected by the BIT	225
b.	Star Holdings SCA’s Investments in Korea Are Protected by the BIT	227
c.	LSF SLF Holdings SCA’s and HL Holdings SCA’s Investments in Korea Are Protected by the BIT	228

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

d.	Kukdong Holdings I SCA's and Kukdong Holdings II SCA's Investments in Korea Are Protected by the BIT	228
e.	Lone Star Capital Management SPRL's and Lone Star Capital Investments S.à.r.l.'s Investments in Korea Are Protected by the BIT	229
2.	Claimants' Investments Are Covered under the ICSID Convention....	230
a.	The Tribunal Should Defer to the Parties' Understanding of "Investment" as Set Out in the BIT	231
b.	Claimants' Korean Assets Possess All the Typical Characteristics of an Investment.....	233
C.	THE DISPUTE IS DERIVED FROM AN ALLEGED BREACH OF THE BIT AND IS A LEGAL DISPUTE THAT ARISES DIRECTLY FROM CLAIMANTS' INVESTMENTS	234
1.	The Dispute Is Derived from an Alleged Breach of the BIT and Therefore Meets the Requirements of Article 8(1) of the BIT.....	235
2.	The Dispute Is a Legal Dispute that Arises Directly from Claimants' Investments and Therefore Meets the Requirements of Article 25 of the ICSID Convention	235
D.	RESPONDENT AND CLAIMANTS HAVE CONSENTED TO ARBITRATION.....	237
E.	THE DISPUTE MEETS THE TEMPORAL REQUIREMENTS OF THE TREATY AND THE ICSID CONVENTION	238
1.	The Breaches Occurred After the BIT and the Convention Entered into Force	239
2.	The Dispute Was Timely Submitted for Resolution	239
F.	ALL PROCEDURAL REQUIREMENTS UNDER THE TREATY AND THE ICSID CONVENTION HAVE BEEN MET.....	240
1.	Claimants Have Satisfied the Procedural Requirements of Article 8(1) of the BIT.....	240
2.	Claimants Have Satisfied the Procedural Requirements of Article 8(3) of the BIT.....	243
3.	Claimants Have Satisfied All Procedural Requirements of the ICSID Convention.....	244
V.	LEGAL ARGUMENTS ON THE MERITS	244

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

A.	KOREA’S ACTS AND OMISSIONS WERE ARBITRARY AND DISCRIMINATORY	247
1.	Respondent’s Failure to Approve the KEB Sale.....	250
2.	Respondent’s Unlawful Taxation	260
B.	KOREA’S ACTS AND OMISSIONS DENIED CLAIMANTS FAIR AND EQUITABLE TREATMENT.....	265
1.	Korea Failed to Protect the Investors’ Legitimate Expectations.....	268
a.	Respondent’s Failure to Approve the KEB Sale.....	271
b.	Respondent’s Unlawful Taxation	274
(i)	<i>Basis of Claimants’ Legitimate Expectations</i>	<i>274</i>
(ii)	<i>Claimants Had a Legitimate Expectation that They Would Receive the Benefits of the Korea-Belgium Tax Treaty</i>	<i>276</i>
(iii)	<i>Claimants Had a Legitimate Expectation that, in the Event of a Dispute over Whether They Were Bona Fide Belgian Residents, Korea Would Comply with the Dispute Resolution Procedures of the Tax Treaty.....</i>	<i>279</i>
(iv)	<i>Claimants Had a Legitimate Expectation that, Even if Korea Disregarded Them, Their Ultimate Investors Would Be Protected by Applicable Tax Treaties.....</i>	<i>280</i>
(v)	<i>Claimants’ Legitimate Expectations Were Undermined by the NTS “Roller Coaster” with Respect to the Question of Whether a Permanent Establishment Existed.....</i>	<i>282</i>
(vi)	<i>Respondent’s Tax Assessments Violated Korea’s Obligation of Fair and Equitable Treatment.....</i>	<i>283</i>
2.	Korea Failed to Act in Good Faith	286
a.	Respondent’s Failure to Approve the KEB Sale.....	287
b.	Respondent’s Unlawful Taxation	289
3.	Korea Failed to Provide Procedural Propriety or Due Process	290
a.	Respondent’s Failure to Approve the KEB Sale.....	292
b.	Respondent’s Unlawful Taxation	294

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

C.	KOREA FAILED TO PROVIDE FULL AND CONTINUOUS PROTECTION AND SECURITY.....	296
1.	Respondent’s Failure to Approve the KEB Sale.....	299
2.	Respondent’s Unlawful Taxation	302
D.	KOREA FAILED TO PROVIDE MOST FAVOURED NATION AND NATIONAL TREATMENT.....	303
E.	KOREA EXPROPRIATED CLAIMANTS’ INVESTMENTS	306
F.	KOREA FAILED TO OBSERVE ITS OBLIGATIONS WITH RESPECT TO CLAIMANTS’ INVESTMENTS (UMBRELLA CLAUSE).....	312
G.	KOREA VIOLATED ITS OBLIGATIONS TO ALLOW FREE TRANSFERS	318
VI.	DAMAGES	320
A.	CLAIMANTS ARE ENTITLED TO COMPENSATION FOR DEPRIVATION OF THEIR TREATY RIGHTS	320
B.	CALCULATION OF DAMAGES	324
1.	Damages for Failure to Approve the KEB Sale	325
2.	Damages for Wrongful Taxation	327
C.	INTEREST	332
D.	GROSS-UP FOR TAXES ON THE AWARD	334
E.	ARBITRATION COSTS	336
VII.	RELIEF REQUESTED.....	336

I. EXECUTIVE SUMMARY

1. This dispute is primarily about the refusal of Korean financial regulators to allow a Belgian investor—an investment company of the Lone Star Funds (collectively “Lone Star”)—to sell its stake in a large Korean bank and receive the proper return on its investment. The motivation for the regulators’ actions arose from a complex mix of cultural, political, and economic circumstances. At its core, however, the reason was simple. The regulators feared the public and political backlash that would come from allowing Lone Star to profitably sell its stake in the bank, and, in order to avoid personal and political ruin, they concocted every conceivable excuse to avoid having to approve a sale. Then, when the government was finally willing to grant approval, it looked for any available way to reduce Lone Star’s economic gain, whether through forced price reductions or arbitrary taxation. All of this was done without regard to legality or policy justification, and each of these acts breached Korea’s obligations under the investment treaty between Korea and Belgium and Luxembourg.

2. The start of the story, however, presented a much different picture. In 2003, while the Korean economy was still reeling from the aftershocks of the 1997 Asian financial crisis, Korea Exchange Bank (“KEB”), one of the most prestigious banks in Korea, was on the verge of insolvency. KEB needed a massive capital injection to keep it afloat. The Korean government was unwilling or unable to step in, and instead instructed the bank to look for foreign capital. Given the risks and complexity of investing such a large sum in the struggling bank, only one entity, Lone Star, was willing to make the investment.

3. It would be reasonable to assume that, in these circumstances, Lone Star would have been viewed as a respected, welcome participant in the Korean economy. In fact, the promising beginning of the story makes the end all the more remarkable. Over the next several

years, the political tides shifted, and Lone Star became a pariah, condemned as a foreign plunderer that could not be allowed to leave Korea with the profits from its sizable and highly risky investment. In essence, Lone Star found itself behind a one-way door. It was allowed to enter Korea and invest over a billion dollars in a large, ailing bank at a time when the Korean economy as a whole was in crisis, but it was not allowed to leave with the proceeds of that investment.

4. Lone Star is a private equity firm specializing in distressed assets. It was, and is, a highly sophisticated, successful, and well-respected investor. Investors in the Lone Star funds include government pension funds, university endowments, and sovereign wealth funds, including the IMF and United Nations pension funds.

5. The nature of Lone Star's business was well known. Lone Star would work to turn the bank around and then, within a few years, sell its stake at a profit. That was the entire motivation for Lone Star's investment, and that was why the sale to Lone Star was subject to a two year "lock up" period, meaning that Lone Star could not sell its stake for two years. During that time, Lone Star would work to return KEB to financial health and increase its value. After the expiration of that period, Lone Star would be free to exit.

6. Given KEB's poor condition, Lone Star understood that its investment was risky. But assessing such risks, and finding opportunities in difficult settings, was the essence of Lone Star's business, and it believed it was making a sound investment. Its expectations and commercial strategy were based not only on its due diligence with respect to KEB but on its experience investing in distressed assets, including distressed banks, in markets around the world.

After the deal had closed, however, Lone Star quickly learned that Korea did not operate as other markets did.

7. In Korea, the government, the banks, and industry are deeply intertwined, and collectively they form “Korea, Inc.”, a state-led economy in which the government formally or informally directs or guides the interactions of public and private sector actors with the goal of promoting indigenous economic growth. By virtue of Lone Star’s investment in KEB, Lone Star was pulled into this web. Yet, ironically, it was precisely that close intertwining of government and business that had laid the foundations for the economic crisis in Korea in the late 1990s and for KEB’s economic difficulties that ultimately led to Lone Star’s investment in the first place.

8. For decades, the government had directed Korean banks to lend at unsustainable levels to fund the development of Korean industry. As a result, Korea was exceedingly vulnerable to the economic shock that came with the Asian financial crisis in 1997. The economy collapsed and the International Monetary Fund (“IMF”) had to step in with the largest bailout for a single country in its history. KEB itself was hit hard by the crisis. The crisis, the bailout, and the reforms that followed brought out a latent resentment against foreign intervention in Korea. Foreign investors were needed but they were not to be trusted and, most importantly, they could not be permitted to benefit from Korea’s economic difficulties. That sentiment came fully to the fore several years later when Lone Star went to sell its stake in KEB.

9. Korea undertook various legal reforms to avoid a recurrence of the problems that led to the crisis, but the government nevertheless continued to play a heavy role in day-to-day commercial operations in Korea. Lone Star’s first exposure to this phenomenon came just days after its investment in KEB, when the Korean government demanded that KEB rescue Korea

Exchange Bank Credit Services Co. Ltd. (“KEB Card”), a credit card company in which KEB held a stake and which was on the verge of bankruptcy.

10. Lone Star had done its due diligence and knew of the problems at KEB Card when it invested in KEB, but it was fully prepared to let the company fail. The Korean regulators, however, were not. No sooner had Lone Star invested in KEB than the Korean government demanded that KEB save KEB Card. Coming from its regulator, this was a directive that could only be refused at KEB’s peril. Lone Star was shocked by the government’s intervention, but eventually agreed. What this meant, however, was that virtually the entire amount of Lone Star’s \$1 billion investment in KEB was diverted to save KEB Card.

11. To make matters worse, the merger antagonized the KEB Card labor union, which, fearing layoffs, protested the merger, occupied the KEB Card offices, and stormed the office of the KEB Card Chief Executive Officer (“CEO”). Events surrounding the merger ultimately led to the creation of Spec Watch, an anti-foreign capital activist group co-founded by the former head of the KEB Card union who publicly swore that he would “get even” with Lone Star and then made it his mission over the next several years to inflame public opinion against Lone Star. Over time, he was joined by other activist groups, unions, and media.

12. Despite the rude awakening of the KEB Card experience, Lone Star continued to work to put KEB on a firm financial footing. Lone Star’s investment strategy would only work if it were able to restore the bank to health, and thereby increase the value of Lone Star’s stake in the bank. And that is exactly what Lone Star did. The performance of the bank immediately and dramatically improved, and within two years the bank earned record profits. At the end of the

two-year lock-up period, Lone Star was prepared to sell its stake, and many investors lined up as potential suitors.

13. However, Lone Star's attempts to sell the bank would hit a wall. Between the time of Lone Star's initial acquisition and the time it sought to sell its stake in KEB, a deep and growing disconnect had emerged between the sterling performance of the bank and the perception of Lone Star by the Korean public, politicians and regulators. And here, the unique cultural context of Korea played a critical role.

14. In the minds of many in Korea, it is the duty of investors first and foremost to serve Korea, and only secondarily to pursue commercial interests. For historical reasons, many Koreans are suspicious of foreigners, whom they feel do not act in the interests of Korea and are there only to exploit the country and plunder its wealth. To some, the entire idea of private equity investments in distressed assets, in which an investor acquires a distressed company, returns it to a firm footing, then sells it at a profit, fits neatly into this narrative. As a result, many Koreans were predisposed to resent Lone Star's role in KEB, despite the fact that Lone Star ultimately rescued the iconic Korean bank from insolvency, returned it to record profitability, and saved thousands of jobs. Over the course of several years, that predisposition erupted into full-fledged hostility.

15. The evolution of the Lone Star saga unfolded in three stages. In the first stage, several events triggered a violent backlash among the public and the media against Lone Star. In the second stage, politicians seized on the controversy, demanding investigations and prosecutions in an effort to advance their own political agendas. In the third stage, the public

and political opposition to Lone Star crystallized into a government policy dead set against allowing Lone Star to exit Korea with the full value of its investment.

16. Four events set off the initial public backlash against Lone Star. First, soon after Lone Star acquired its stake in KEB, several other private equity investors who had also invested in Korean banks sold their stakes at a substantial profit. Such behavior in itself pricked Korean sensibilities, but the fact that two of these investors—The Carlyle Group (“Carlyle”) and Newbridge Capital (“Newbridge”)—were protected by tax treaties, and therefore did not pay taxes in Korea on the proceeds of their sales, exacerbated public reaction. Lone Star was the third in line, and by the time it was prepared to sell, Korean resentment toward private equity investors, and Lone Star in particular, had risen to a fever pitch.

17. Second, in the wake of the controversy surrounding the bank sales by Carlyle and Newbridge, the Korean tax authorities decided to bring the hammer down on private equity firms. According to a member of the National Assembly who was assessing how best to tax Lone Star, “The tax issue of Lone Star does not depend on the factual grounds but rather on political choice and will.” The Korean National Tax Service (“NTS”) made it its mission to find every conceivable way to penalize the funds. As stated by NTS Commissioner Ju-sung Lee, any failure to “get” the foreign investment funds “would have been tantamount to Korea’s defeat in a power game with the overseas hedge funds.” Despite the fact that there was no allegation of wrongdoing against Lone Star, the tax authorities raided Lone Star’s facilities, conducted illegal searches without a warrant or consent, and seized reams of proprietary documents. The raids created suspicion and further inflamed public opposition.

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
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18. Third, in the course of the tax raids and audits, Lone Star discovered that one of its employees, Steven Lee, had embezzled \$12 million from Lone Star. Lone Star reported the crime to the tax authorities, who then told Lone Star that they would look the other way if Lone Star paid substantial, illegal tax assessments. Lone Star refused. Despite the fact that Lone Star, not KEB or the Korean government, was the victim of Steven Lee's embezzlement, the episode further tainted the public's view of Lone Star.

19. Finally, in parallel with these events, civic groups like Spec Watch, unions, and the media began a public campaign against Lone Star. Several civic groups launched lobbying and litigation campaigns against Lone Star. Spec Watch coined the term "eat and run" to describe foreign investors who invested in Korean companies, earned a profit, and then left the country. That concept grabbed the public imagination and led to a further outpouring of anger.

20. Over time, aspiring politicians, one of whom was soon to proclaim herself "the Lone Star sniper," seized on the issue. Members of the Korean legislature issued reports purporting to reveal the "conspiracy" behind Lone Star's acquisition of KEB. A barrage of criminal and civil investigations and audits followed, challenging among other things Lone Star's initial acquisition of KEB and KEB's merger with KEB Card.

21. In the face of this hostility, the government closed ranks, and it became an unwritten rule that regulators simply would not allow Lone Star to sell its stake in KEB and leave the country with a substantial profit. Regulators feared for their livelihood and personal well-being if they took any action to facilitate Lone Star's attempted sales. The paralysis among government officials was so pervasive that it became known as "Byeon Yang-ho syndrome,"

named after a government official who was harassed, prosecuted, and imprisoned (although ultimately found not guilty) for his role in approving Lone Star's acquisition of a stake in KEB.

22. As opposition grew, Korean laws and regulations were changed specifically to target Lone Star. Financial laws and regulations were amended specifically to give the regulators new (and unconstitutional) authority to block Lone Star's attempt to sell its stake in KEB. One legislator who sponsored a new tax proposal proclaimed proudly that "[w]e have no intention of hiding that the bill is targeting Lone Star."

23. In the midst of these events, Lone Star's attempts to sell its stake in KEB foundered. Lone Star's first attempt to sell its stake, to Kookmin Bank ("Kookmin"), was not only embroiled in the political controversy, but had difficulties clearing antitrust (competition) review and was ultimately thwarted by the parties' diverging views on the appropriate price for the deal.

24. By the time Lone Star tried again, with a different buyer, controversy had crystallized into a policy of paralysis—no one in the government had the political courage to let the deal go through. Lone Star entered into a new sale agreement, this time with HSBC Asia Pacific Holdings (UK) Limited ("HSBC"), which was at the time one of the strongest and most well-respected banks in the world. In order to close the deal, HSBC needed to obtain the approval of the Korean Financial Supervisory Commission (from 2008 on, the Financial Services Commission ("FSC")). Like many other modern regulatory systems, Korean law gives the financial regulators the opportunity to review potential bank acquisitions to ensure that the acquisition will not undermine the soundness of the banking system and to ensure that potential acquirers have the resources to manage the bank competently and prudently. To this end,

regulators around the world extensively review the qualifications of an acquirer and, on that basis, have the authority to approve or disapprove the proposed acquisition. There was absolutely no doubt that HSBC was a qualified acquirer.

25. The problem, however, was that the FSC did not focus on HSBC. Instead, the FSC refused to act on HSBC's application because of Lone Star. There was no basis whatsoever in Korean law for the FSC to do so. The position of the seller is wholly irrelevant to whether an application to acquire a bank should be approved. Issues regarding the seller, particularly if the seller is disposing of its entire stake in the bank, have nothing to do with whether the bank will be run soundly by the proposed *acquirer*. The FSC's refusal to act on HSBC's applications was, therefore, illegal and an abuse of discretion.

26. Despite the FSC's inaction, however, there were times during the course of the FSC's review when HSBC and Lone Star had a glimmer of hope, in particular when a new President came into office with a promise to fix the problem. However, external political circumstances intervened. The President's decision to allow U.S. imports of beef into Korea despite public concerns over mad cow disease sparked ferocious public protests, drained the administration's political capital, and doomed any prospect of action on HSBC's application. The Chairman of the FSC candidly stated that in light of the public outrage related to the government's plan to import US beef, the FSC would have no choice but to "consider the public sentiment" in the handling of the HSBC case.

27. The statutory deadline for deciding on HSBC's application came and went, and even when, four months after the application was filed, HSBC and Lone Star extended the termination date for the sales agreement for yet another three months, the FSC refused to act. As

the months went by, the world changed. The financial crisis hit in September 2008, and, after nine months of waiting for the FSC to act, HSBC terminated the sales agreement.

28. Two years later, as the global financial crisis receded, Lone Star tried again. In November 2010, Lone Star agreed to sell its stake in KEB to a Korean financial institution, Hana Financial Group, Inc. (“Hana”). Given the changed economic and political environment, Hana and Lone Star came to terms on a much lower price than HSBC had been willing to pay. Hana also needed to obtain the FSC’s approval before closing the deal. And, again, the FSC refused to act. As with the aborted HSBC transaction, the statutory deadline for deciding on Hana’s application came and went. The parties agreed to extend the termination date for the sales agreement, and still, nothing happened. The FSC continued to point to issues surrounding the seller, Lone Star, as an excuse for failing to take action.

29. A small window of opportunity opened in February 2011, when the FSC appeared poised to approve the acquisition. However, once again, external factors intervened. For years, a criminal proceeding had been pending against one of KEB’s directors nominated by Lone Star, Paul Yoo, for alleged stock price manipulation related the merger of KEB Card into KEB (and against KEB and Lone Star’s Belgian owner of KEB, LSF-KEB Holdings SCA (“LSF-KEB”) based on vicarious liability). In the lower courts, Mr. Yoo (and thus LSF-KEB) had been acquitted of the charges. However, soon after the FSC signaled its intent to approve the Hana acquisition, the acquittals were overturned, which gave the FSC yet another excuse not to act on Hana’s application. Mr. Yoo was then convicted and LSF-KEB was ultimately found vicariously liable. Lone Star had the opportunity to appeal the guilty verdict, but chose not to do so in order to take away the FSC’s excuse for inaction on its pending sale. At this point, the FSC’s behavior turned surreal.

30. In the wake of the guilty verdict, the FSC ordered LSF-KEB to bring itself into compliance with the law (*i.e.*, not be guilty of violating a financial law), which of course LSF-KEB could not do as the conviction had become final. Indeed, the FSC's order recognized as much with the Kafkaesque statement that "[t]he three day grace period was granted because compliance with the foregoing order was in fact not possible." As a result, and in light of the fact that Korean law prohibited an entity that had been convicted of violating financial laws from owning a bank, the FSC decided that Lone Star was no longer permitted to own its large stake in KEB. The FSC stripped Lone Star of most of its voting rights and tried to force the removal of the Lone Star-appointed directors of KEB. Bizarrely, the FSC also ordered Lone Star to reduce its shareholding to no more than 10% of the outstanding shares of KEB. The sale order was absurd and hypocritical given that Lone Star wanted nothing more than to sell its shares in KEB—but it was the FSC itself that was refusing to approve Hana's application to buy them. The FSC was simultaneously ordering Lone Star to sell its shares and preventing Lone Star from doing exactly that.

31. The point of this exercise soon became clear. The FSC was buying time and laying the groundwork to force Lone Star to reduce the price. The government made a political calculation that it could finally let Lone Star exit its investment, but only if it was seen as cutting back Lone Star's profits. While the FSC was spending time issuing its various unnecessary and illogical compliance and disposal orders, the sale agreement with Hana expired. The FSC then made it clear that "changed circumstances"—namely, the compliance and disposal orders that the FSC itself issued—required Hana to submit a new application for a renegotiated agreement at a reduced price. The FSC had no legal authority to force the parties to reduce the agreed price, and so it instead surreptitiously instructed Hana to demand a lower price and let it be known that

no approval would be forthcoming until Lone Star agreed. Given that the deadline for complying with the FSC's sale order was fast approaching, Lone Star was faced with a choice of either agreeing to a lower price with Hana or selling its shares on the open market, which would have been commercially disastrous. Lone Star and Hana agreed to a lower price, and the FSC finally approved the deal on January 27, 2012, thirteen months after Hana originally filed its application.

32. But still that was not enough to satisfy the public demand that Lone Star be punished for its temerity in seeking to earn a profit on its investment. The regulators felt that they needed to do more and were intent on extracting as much economic value from Lone Star as possible, regardless of the legality of their actions. Thus, when Lone Star sought to obtain a dividend to which it was rightly entitled, Hana made it clear that the FSC would not let that happen.

33. However, the more direct, and certainly more heavy-handed, way that the government made Lone Star pay was through taxation. Taxes should not have been at issue because the taxation of the Claimants' (defined below) investment income was governed by the Korea-Belgium Tax Treaty, which set a reduced rate on dividends and fully exempted capital gains from taxation in Korea. In accordance with that treaty, Claimants timely and properly paid hundreds of millions of U.S. dollars in taxes on the dividends that they received from their investments between 2004 and 2012. But Lone Star's substantial contribution to the Korean government fisc was evidently not enough. In the Korean government's political calculation, Lone Star could not be permitted, under any circumstances, to reap the rewards of its Korean investments without first paying massive, punitive taxes. Respondent's solution to this conundrum was brutally efficient. It would simply ignore the Tax Treaty, and disregard

corporate formalities, decades of precedent, and international practice in order to bypass Claimants and assess taxes at the highest conceivable rate. The tax authorities were determined to take whatever measures were necessary to maximize Lone Star's tax liability, no matter how inconsistent or legally questionable those measures might be: Claimants were denied the benefits of the Korea-Belgium Tax Treaty contrary to the treaty and Korean law; upon disregarding the Belgian Claimants, the NTS either did or did not identify the alternative taxpayers, as it suited their assessments; over the course of several different assessments, the NTS did not find, then found, then again did not find the taxpayers to have a "permanent establishment" in Korea; and the NTS even taxed Lone Star entities under the higher tax rate applicable to individuals and non-profits such as churches. Thus, through a series of arbitrary, illegal, and inconsistent measures, the tax authorities impermissibly extracted hundreds of millions of dollars of taxes from Lone Star.

34. As explained in detail below, the actions and inactions of the Korean government violate multiple provisions of the BIT, including (a) the prohibition in Article 2(3) against arbitrary or discriminatory measures that impair the operation, management, maintenance, use, enjoyment or disposal of investments; (b) the guarantee of fair and equitable treatment in Article 2(2); (c) the guarantee of full and continuous protection and security in Article 2(2); (d) the guarantee of most favoured nation and national treatment in Articles 3(1) and 3(2); (e) the guarantee against expropriation of investments without prompt, adequate, and effective compensation under Article 5; (f) the obligation to observe written undertakings that have entered into force with regard to investments under Article 10(3); and (g) the guarantee of free transfers in Article 6.

35. Respondent's refusal to approve HSBC's application to acquire Lone Star's stake in KEB resulted in damages to Claimants of \$2,910.4 million. Respondent's unlawful tax assessments have resulted in further damages of \$1,468.2 million.

II. INTRODUCTION

36. Claimants in this dispute are seven Belgian companies, including LSF-KEB, LSF SLF Holding SCA, HL Holdings SCA, Kukdong Holdings I SCA, Kukdong Holdings II SCA, Star Holdings SCA, and Lone Star Capital Management SPRL, and one Luxembourg company, Lone Star Capital Investments S.à.r.l. (collectively “Claimants”). Respondent in this dispute is the Republic of Korea. This dispute arises under the Agreement Between the Government of the Republic of Korea and the Belgium-Luxembourg Economic Union for the Reciprocal Promotion and Protection of Investments (“the Treaty” or “the BIT”).

37. Section III below provides a statement of the facts underlying this dispute. Section IV explains that the Tribunal has jurisdiction over this dispute under the BIT and the ICSID Convention. Section V sets out Claimants’ arguments that Korea’s actions violate the BIT. Section VI explains Claimants’ damages claims, and, finally, Section VII provides Claimants’ prayer for relief.

III. STATEMENT OF FACTS

38. The following Section provides a summary of the facts relevant to this dispute, beginning with (A) an explanation of the economic circumstances that placed KEB in severe financial difficulty and resulted in KEB seeking foreign investors to save it from insolvency. We then explain (B) Lone Star’s acquisition of a majority stake in KEB; (C) the circumstances of the merger of KEB with KEB Card; (D) the financial turnaround of KEB under Lone Star’s control; (E) and (F) the shifting public and political opinions regarding Lone Star; (G) how those public and political opinions hardened into a government policy effectively blocking any acquisition of Lone Star’s stake in KEB; (H) Lone Star’s sale of a block of its KEB shares on the open market; (I) Lone Star’s attempts to sell its remaining stake in KEB to HSBC; (J) Lone Star’s attempts to

sell its remaining stake in KEB to Hana; (K) the ongoing harassment of Lone Star; and (L) the facts of the government's aggressive and unlawful attempts to maximize taxes assessed against Lone Star and thereby curtail its profits.

A. THE ORIGINS OF KEB'S FINANCIAL DIFFICULTIES

39. This Section explains the origins of KEB's financial distress, Korea's unwillingness to rescue the bank, and the government's attempts to encourage foreign investors like Lone Star to save the bank from insolvency.

40. KEB's financial distress arose out of the broader fracturing of the Korean economic model in the late 1990s. As explained further below, the explosive economic growth Korea experienced between the end of the Korean War and the late 1990s was driven by a strong government-private sector arrangement, colloquially described as "Korea, Inc." This was a state-driven economic model in which the government sat at the top, directing the actions of private industrial conglomerates and financial institutions. Korea, Inc. was phenomenally successful for many years—so much so that, in 1996, Korea became the 29th member of the Organization for Economic Cooperation and Development ("OECD"), joining the ranks of the world's wealthiest and most advanced economies.¹

41. However, that same economic model created dangerous fault lines that lurked below the surface. Government direction led to reckless lending by banks and borrowing by industrial enterprises, leaving the system vulnerable to financial shocks. When the Asian financial crisis hit in the late 1990s, the Korean economy was shaken to its core. A region-wide currency crisis compounded the effects of several large corporate bankruptcies, touching off a

¹ See Kwan S. Kim, *The 1997 Financial Crisis and Governance: The Case of South Korea*, KELLOGG INSTITUTE, WORKING PAPER #272 (2000), at 5 ("Kim, *The 1997 Financial Crisis and Governance*") [Exhibit C-044].

speculative attack on the Korean won (“KRW”).² Foreign capital poured out of the country, bankrupting companies dependent on short-term foreign debt and plunging the economy deeper into crisis.³ Facing economic collapse, Korea was forced to accept a politically humiliating \$57 billion bailout from the IMF, the largest ever given to a single country.⁴

42. Korea eventually recovered from the 1997 crisis, but only after a wrenching period of restructuring that saw the closure of hundreds of financial institutions, the consolidation of dozens more, and the overhaul of the country’s financial regulatory system.⁵ The crisis would leave a lasting impression on the national consciousness and define the direction of Korea’s economic policy for years to come. It would also set in motion the events at the heart of this dispute, beginning with the government’s post-crisis campaign to attract private equity investors to the Korean banking sector.

43. KEB emerged from the Asian financial crisis in one piece but badly undercapitalized, and by the early 2000s the bank was headed toward insolvency. The Korean government was unwilling to intervene, and encouraged KEB to seek foreign sources of capital. As discussed below, Lone Star was the only investor willing to step in.

44. This Section of the Statement of Facts provides a history of the 1997 financial crisis, focusing on (1) the primary causes of the crisis, including the short-term triggers and the

² See Yung Chul Park, *The Financial Crisis in Korea and Its Lessons for Reform of the International Financial System*, FONDAD 15 (1998) (“Park, *The Financial Crisis in Korea*”) [Exhibit C-034].

³ See Park, *The Financial Crisis in Korea* at 15-18 [Exhibit C-034].

⁴ See Gregory P. Corning, *Managing the Asian Meltdown: The IMF and South Korea*, INSTITUTE FOR STUDY OF DIPLOMACY 1 (2000) (“Corning, *Managing the Asian Meltdown*”) [Exhibit C-042].

⁵ See Chung-In Moon & Jongryn Mo, *Economic Crisis and Structural Reforms in South Korea*, ECONOMIC STRATEGY INSTITUTE 7 (2000) (“Moon & Mo, *Economic Crisis and Structural Reforms in South Korea*”) [Exhibit C-043].

long-term weaknesses in Korea's development model; (2) the Korean government's response to the crisis, both in terms of the immediate measures taken to stabilize the financial sector and the long-term regulatory reforms put in place to prevent a similar crisis in the future; (3) the impact of the financial crisis on Korean attitudes toward foreign investment; and (4) the impact of the crisis on KEB and KEB's attempts to attract foreign capital.

1. Korea's Economic Model Leads to Economic Meltdown

45. The Korean "economic miracle" in the decades prior to the 1997 financial crisis grew out of a strategic alliance between the government and a handful of family-run industrial conglomerates or "*chaebol*."⁶

46. In return for carrying out the government's industrial strategy, the *chaebol* were able to borrow from state-owned commercial banks on favorable terms.⁷ This arrangement let the government channel capital to firms aligned with its policy of export-led growth while allowing the *chaebol* to expand at rates that would have been inconceivable were they required to reinvest their own profits.⁸ The government urged the *chaebol* to invest in strategic industries like steel, consumer electronics, and petrochemicals,⁹ and the *chaebol* invested accordingly, confident that the government, through a combination of cheap credit, tax exemptions, and export subsidies, would guarantee the profitability of their investments.¹⁰ The more the *chaebol*

⁶ See Kim, *The 1997 Financial Crisis and Governance* at 5 [Exhibit C-044].

⁷ See Anne O. Krueger & Jungho Yoo, *Chaebol Capitalism and the Currency-Financial Crisis in Korea*, National Bureau of Economic Research 10-11 (2002) ("Krueger & Yoo, *Chaebol Capitalism*") [Exhibit C-047].

⁸ See Krueger & Yoo, *Chaebol Capitalism* at 10-11 [Exhibit C-047].

⁹ See Angel Ubide & Tomás J. T. Baliño, *The Korean Financial Crisis of 1997 - A Strategy of Financial Sector Reform*, INTERNATIONAL MONETARY FUND WORKING PAPER 11 (1999) ("Ubide & Baliño, *The Korean Financial Crisis of 1997*") [Exhibit C-037].

¹⁰ See Krueger & Yoo, *Chaebol Capitalism* at 10-11 [Exhibit C-047].

borrowed, the more rapidly they expanded, and the more they expanded, the more the government directed Korean banks to reward them with new loans.¹¹

47. By the 1990s, decades of government-directed lending had created an unhealthy codependency between the commercial banks and the *chaebol*.¹² The *chaebol* relied on the banks for preferential access to credit, and the banks, having failed to diversify their loan portfolios, relied on the *chaebol* to keep borrowing.¹³ Because it was understood that the government would protect the *chaebol* from bankruptcy, the banks lent to the *chaebol* with abandon, and the *chaebol* tended to carry significantly more debt than equity. This made the *chaebol* risky borrowers, because highly leveraged firms have thin capital cushions that make them vulnerable to economic shocks.¹⁴

48. The 1990s saw a surge in the demand for foreign capital.¹⁵ The *chaebol* were aggressively seeking out new export industries, and they needed foreign inputs to run their factories.¹⁶ At the same time, the Korean government relaxed restrictions on short-term foreign loans, and many Korean firms and banks were eager to take advantage of comparatively lower

¹¹ See Park, *The Financial Crisis in Korea* at 7-8 [Exhibit C-034].

¹² See Park, *The Financial Crisis in Korea* at 8 [Exhibit C-034].

¹³ See Park, *The Financial Crisis in Korea* at 15-18 [Exhibit C-034].

¹⁴ See John W. Head, *The Asian Financial Crisis in Retrospect—Observations on Legal and Institutional Lessons After a Dozen Years*, E. ASIA L. REV. 31, 45-46 (2010) (“Head, *The Asian Financial Crisis in Retrospect*”) [Exhibit C-217].

¹⁵ See Joon-Ho Hahm & Frederic S. Mishkin, *Causes of the Korean Financial Crisis: Lessons for Policy*, NATIONAL BUREAU OF ECONOMIC RESEARCH WORKING PAPER NO. 7483 at 21 (2000) (“Hahm & Mishkin, *Causes of the Korean Financial Crisis: Lessons for Policy*”) [Exhibit C-041].

¹⁶ See Hahm & Mishkin, *Causes of the Korean Financial Crisis: Lessons for Policy* at 22 [Exhibit C-041].

foreign interest rates.¹⁷ During the ensuing investment rush, foreign debt rose from \$43 billion in 1992 to \$120 billion in 1997, mostly as a result of short-term borrowing.¹⁸

49. Reliance on short-term foreign debt (or, more precisely, foreign currency-denominated debt) left the Korean economy vulnerable to fluctuations in the international capital markets.¹⁹ Short-term debt is more volatile than long-term debt or foreign direct investment because of the ease with which it can be withdrawn.²⁰ In Korea's case, the risk of capital flight was compounded by weaknesses in the domestic banking system, which was overexposed to the *chaebol*.²¹ Because *chaebol* debt comprised a substantial share of bank balance sheets, the risk of *chaebol* failure was concentrated in the Korean financial sector.²²

50. Following a dramatic slowdown in exports in 1996, the Korean manufacturing sector began showing signs of distress. In January 1997, Hanbo Steel, the fourteenth-largest *chaebol*, declared bankruptcy, followed in short order by a handful of other conglomerates, including Sammi Steel and Jinro, and later Kia Motors.²³ These bankruptcies dealt a serious blow to investor confidence, which had already been rattled by currency crises in Thailand and Indonesia, and which would soon hit bottom in December 1997, when Standard & Poor's downgraded Korea's sovereign credit rating. By the end of 1997, six of the 30 largest

¹⁷ See Hahm & Mishkin, *Causes of the Korean Financial Crisis: Lessons for Policy* at 22 [Exhibit C-041].

¹⁸ See Kang-Kook Lee, *The Post-Crisis Changes in the Financial System in Korea: Problems of Neoliberal Restructuring and Financial Opening After 1997*, THIRD WORLD NETWORK GLOBAL ECONOMY SERIES NO. 20 (2010), at 13 [Exhibit C-214].

¹⁹ See Bang Nam Jeon, *From the 1997-98 Asian Financial Crisis to the 2008-09 Global Economic Crisis: Lessons from Korea's Experience*, 5 E. Asia L. Rev. 103 (2010), at 111-12 ("Jeon, *From the 1997-98 Asian Financial Crisis to the 2008-09 Global Economic Crisis*") [Exhibit C-216].

²⁰ See Jeon, *From the 1997-98 Asian Financial Crisis to the 2008-09 Global Economic Crisis* at 116-17 [Exhibit C-216].

²¹ See Park, *The Financial Crisis in Korea* at 8-9 [Exhibit C-034].

²² See Park, *The Financial Crisis in Korea* at 8-9 [Exhibit C-034].

²³ See Park, *The Financial Crisis in Korea* at 18 [Exhibit C-034].

conglomerates had been declared insolvent.²⁴ The bankruptcies also triggered a banking crisis: of the 26 commercial banks in Korea, more than half had capital adequacy ratios below the required 8% threshold, and two were declared insolvent. The figures were even more alarming for the merchant banks, with 28 of 30 having fallen below required capital levels, and 12 declaring insolvency.²⁵

51. By mid November, the Korean currency had lost 75% of its value compared to its mid-1997 high.²⁶ As the value of the won depreciated, the cost of servicing dollar-denominated debt shot up. At the end of 1997, Korean companies owed \$77 billion in short-term foreign debt, but with foreign banks withdrawing deposits from Korean branches, and with foreign creditors refusing to roll-over their loans to avoid further exposure, foreign currency was in dangerously short supply. Korea's total foreign exchange reserves fell from \$22.3 billion in October 1997 to \$7.3 billion in November 1997, prompting a panicked Korean government to accept a \$57 billion bailout package from the IMF.²⁷

52. Notwithstanding the IMF bailout, the Korean banking sector continued to spiral out of control.²⁸ Total foreign lending dropped from \$100 billion to \$20 billion in the course of two months.²⁹ Interest rates shot up, bad loans continued to accumulate, and the government was unable to intervene. By the end of 1997, nearly a third of Korea's major commercial banks

²⁴ See Park, *The Financial Crisis in Korea* at 18 [Exhibit C-034].

²⁵ See Ubide & Baliño, *The Korean Financial Crisis of 1997* at 30 [Exhibit C-037].

²⁶ See Beatriz Pont et al., *The Financial Crises in East Asia: The Cases of Japan, China, South Korea, and Southeast Asia*, COMPULTESE INSTITUTE FOR INTERNATIONAL STUDIES WORKING PAPERS PART 3 NO. 11 at 5 (1998) ("Pont, *The Financial Crises in East Asia*") [Exhibit C-036].

²⁷ See Park, *The Financial Crisis in Korea* at 20 [Exhibit C-034].

²⁸ See Park, *The Financial Crisis in Korea* at 19-20 [Exhibit C-034].

²⁹ See Pont, *The Financial Crises in East Asia* at 5 [Exhibit C-036].

were undercapitalized, and at least two were insolvent.³⁰ Ten merchant banks shut down in January 1998 alone, and more bank closures would follow in the ensuing months.³¹

**2. Korea Responds to the Economic Crisis by, Among Other Things,
Taking Measures to Stimulate Foreign Investment**

53. The IMF bailout was conditioned upon Korea's adoption of a series of drastic structural reforms.³² These reforms, which combined the opening of capital markets with the heightening of regulation, were designed to stabilize the Korean economy and shore up investor confidence in its currency.³³ Among other things, Korea would have to close non-viable financial institutions and restructure the financial system, implement new restrictions on the *chaebol*, and open its capital markets to foreign investors by reducing trade barriers and relaxing restrictions on foreign ownership of financial companies.³⁴

a. Rescuing the Financial Sector

54. Korea's post-crisis recovery unfolded in two stages. During the first stage, between 1998 and 2000, the focus was on stabilizing the banking sector.³⁵ The government injected approximately KRW 64 trillion into the financial sector³⁶ and closed dozens of failing

³⁰ See Hyekung Cho & Thomas Kalinowski, *Bank Nationalization, Restructuring and Reprivatization: The Case of Korea since the Asian Financial Crisis*, 41 KOREA OBSERVER 1, 5 (2010) ("Cho & Kalinowski, *Bank Nationalization, Restructuring and Reprivatization*") [Exhibit C-213].

³¹ See Pont, *The Financial Crises in East Asia* at 5 [Exhibit C-036].

³² See Public Fund Management White Paper, Section 2, 2000 ("White Paper, Public Funds Report, 2000") at 59 [Exhibit C-040].

³³ See Jeon, *From the 1997-98 Asian Financial Crisis to the 2008-09 Global Economic Crisis* at 120-21 [Exhibit C-216].

³⁴ See Head, *The Asian Financial Crisis in Retrospect* at 58 [Exhibit C-217].

³⁵ See White Paper, Public Funds Report, 2000 [Exhibit C-040].

³⁶ See White Paper, Public Fund Report, 2000, at 182 [Exhibit C-040]. In January 1998, the government nationalized Korea First Bank and Seoul Bank. Then it announced plans to sell both banks to foreign investors. See White Paper, Public Fund Report, 2000, at 183-84 [Exhibit C-040].

banks.³⁷ During the second stage, which began once stability had been restored in 2001, the government restructured Korea's major banks and financial institutions, facilitating a series of privatizations and strategic mergers that would leave the banking sector highly consolidated and dominated by foreign investors.³⁸ Nearly 40 thousand workers—almost 35% of the banking sector's workforce—were terminated over the course of the restructuring period.³⁹

55. At the end of this process the banking sector was barely recognizable. Failing banks that had not been nationalized or liquidated were swallowed up by larger institutions, leaving a cluster of “mega banks” which together controlled some 86% of Korea's total banking assets.⁴⁰ Meanwhile, the Korean government had become the largest shareholder in the banking sector, with state ownership in bank assets having increased from 33% in 1996 to 54% in 2000.⁴¹

56. Korea desperately needed (and actively sought) foreign capital for the banking sector. Eager to unload its bank shares (and unable to find domestic buyers), the Korean government gradually sold off bank equity to foreign investors.⁴² The ratio of foreign-owned bank equity increased from 14.6% in 1997 to 59.2% in 2004 and to 64.4% in 2007.⁴³ Among the most significant transactions were Newbridge's 1999 purchase for \$417 million of a majority

³⁷ See White Paper, Public Funds Report, 2000 [Exhibit C-040]. Midway through 1998, 13 of the nation's 30 merchant banks had been closed down, and seven commercial banks had been designated “insolvent.” The Act on the Structural Improvement of the Financial Industry (Law No. 6,807, December 26, 2002) Art. 2, para. 3 [Exhibit CA-106]. Another five commercial banks had been forced to merge with larger institutions. White Paper, Public Funds Report, 2000, at 182-83, 198 [Exhibit C-040].

³⁸ See See White Paper, Public Funds Report, 2000, at 12 [Exhibit C-040].

³⁹ See Hyo-sang Yoo, THE INCONVENIENT TRUTH 24 (2012) (unofficial translation) (“Yoo, THE INCONVENIENT TRUTH”) [Exhibit C-286].

⁴⁰ See Hyekyung Cho, *South Korea's Experience with Banking Sector Liberalisation*, CENTRE FOR RESEARCH ON MULTINATIONAL CORPORATIONS RESEARCH REPORT (2010), at 16-17 [Exhibit C-215]; Public Fund Management White Paper 2003 (“White Paper, Public Funds Report, 2003”) at 191 [Exhibit C-315].

⁴¹ See Cho & Kalinowski, *Bank Nationalization, Restructuring and Reprivatization* at 6 [Exhibit C-213].

⁴² See Hwa-Jin Kim, KOREAN BUSINESS LAW 202 (2012) [Exhibit C-285].

⁴³ See Hwa-Jin Kim, KOREAN BUSINESS LAW 202 (2012) [Exhibit C-285].

stake in Korea First Bank (“KFB”), one of the two major commercial banks that were nationalized by the Korean government in the wake of the 1997 crisis; and Carlyle’s 2000 purchase for \$450 million of a 40% stake in KorAm Bank.⁴⁴ As discussed in more detail in Section III.E.1, both Newbridge and Carlyle would later sell their interests to other foreign banks and, by virtue of a tax treaty between Korea and Malaysia, leave Korea without paying taxes on the proceeds of their sales.⁴⁵

b. Regulatory Reforms

57. Many of the imbalances that brought on the 1997 crisis were the result of poor regulatory supervision. Immediately after the crisis, the Korean government implemented a series of reforms that were aimed at taking politics out of financial regulation and bringing Korea’s regulatory system in line with international standards and best practices.⁴⁶ (Despite these legal reforms, that objective was not met in practice, as soon became evident in the Lone Star case.)

(i) *Opening Capital Markets and Attracting Foreign Investors*

58. Korea realized that foreign investors would be an important source of financial stability during Korea’s recovery, and it therefore actively sought to encourage foreign investment. The government eased restrictions on cross-border shareholding in Korean companies⁴⁷ and relaxed regulations on bank ownership, raising the limit on the percentage of outstanding shares that a single foreign purchaser that was not a financial institution could hold

⁴⁴ See Cho & Kalinowski, *Bank Nationalization, Restructuring and Reprivatization* at 10-11 [Exhibit C-213].

⁴⁵ See Statement of Facts, Section III.E.1.

⁴⁶ See Financial Supervisory System in Korea, Financial Supervisory Service Handbook, 2000 (“FSS Handbook”), at 1 [Exhibit C-039].

⁴⁷ See Moon & Mo, *Economic Crisis and Structural Reforms in South Korea* at 37 [Exhibit C-043].

in a single bank without FSC approval from 4% to 10% (although the 4% limit remained in place for Korean shareholders).⁴⁸ Recognizing that 10% was too small a stake to attract foreign investors to invest in distressed banks, the government changed the law in 1998 to permit foreign investors to acquire shares in excess of the 10% limit, provided they obtain FSC approval each time their shareholding exceeded certain thresholds (*i.e.*, 10%, 25%, 33%); in 2002, the exception to the 10% limit was extended to domestic investors.⁴⁹

(ii) *Reining in the Chaebol*

59. The government also took steps to address the collusive relationship between the *chaebol*, the State, and the banks. The crisis seemed to change the Korean public's perception of the *chaebol*. Rather than engines of growth, the *chaebol* were now portrayed as crony capitalists and impediments to the development of a free-market economy.⁵⁰ In line with this view, the government required banks to adopt Western standards of credit evaluation, imposed caps on the amounts banks could lend to a single borrower and its affiliates, and authorized the FSC to monitor transactions between banking institutions and their shareholders.⁵¹

⁴⁸ See Banking Act of Korea (Law No. 6,691, April 27, 2002) ("Banking Act"), Art. 15 [[Exhibit C-048]; Expert Opinion of Prof. Jeong-Woong Baik, at para. 50 ("Baik Expert Opinion") [Exhibit CWE-009]. Although various amendments were made to the Banking Act after 2002, unless otherwise specified, the relevant provisions set forth in the Banking Act (Law 6,691, partially amended April 27, 2002) remain unchanged as of the time periods relevant to this case.

⁴⁹ See Banking Act, Art. 15(3) [Exhibit C-048]; Enforcement Decree, to Banking Act of Korea (Presidential Decree No. 17,717 August 21, 2002), Art. 8(2) [Exhibit C-304]; see also Baik Expert Opinion at para. 50 [Exhibit CWE-009]. Consistent with this approach, in January 2003, the Ministry of Finance and Economy internally reported its "Approach to Privatizing the Banking Sector in 2003," under which the government sought to sell KEB shares held by BOK and KEXIM in the event a suitable investor emerged. See Seoul Central District Court Judgment, Case No. 2006Gohap1352, 1295, 1351, November 24, 2008 at 111 ("Byeon Decision") [Exhibit C-208].

⁵⁰ See Sook Jong Lee, *The Politics of Chaebol Reform in Korea: Social Cleavage and New Financial Rules*, JOURNAL OF CONTEMPORARY ASIA, Vol. 38, No. 3 (2008), at 4 [Exhibit C-173].

⁵¹ See Head, *The Asian Financial Crisis in Retrospect* at 59-61 [Exhibit C-217].

(iii) *Financial Supervision*

60. Prior to 1997, banking, securities, insurance, and non-bank financial services were each supervised by separate Korean regulatory bodies under separate rules and regulations.⁵² On the recommendation of the IMF, the government consolidated all financial sector supervision under the new FSC and Financial Supervisory Service of Korea (“FSS”) and furnished these agencies with regulatory powers commensurate with those exercised by financial regulators in Europe and the United States.⁵³

61. The FSC is a policymaking body with authority to enact and revise banking regulations, issue and revoke bank licenses, and demand corrective action in the event a financial institution’s capital reserves fall below minimum requirements.⁵⁴ Although placed under the Office of the Prime Minister, in practice the FSC operates largely independently.⁵⁵ The FSS is the examination arm of the FSC.⁵⁶ Its responsibilities include supervising and examining Korean financial institutions to ensure their compliance with financial regulations.⁵⁷

62. The FSC was the body charged with approving acquisitions of large shareholdings in Korean banks. As will be explained in further detail in Section III.B.3, it was the FSC that approved Lone Star’s initial investment in KEB. It was also the FSC that later refused to act on successive applications by HSBC and Hana to acquire Lone Star’s shares in KEB, and, when approval was finally granted to Hana, it was the FSC that used its authority as

⁵² See Expert Opinion of Larry Beard (“Beard Expert Opinion”) at para. 27 [Exhibit CWE-010].

⁵³ See Head, *The Asian Financial Crisis in Retrospect* at 58 [Exhibit C-217].

⁵⁴ See Head, *The Asian Financial Crisis in Retrospect* at 58 [Exhibit C-217].

⁵⁵ See FSS Handbook at 65-67 [Exhibit C-039].

⁵⁶ See FSS Handbook at 40 [Exhibit C-039]; Byeon Decision at 91 [Exhibit C-208].

⁵⁷ See FSS Handbook at 40 [Exhibit C-039].

leverage to force a price reduction. The FSC was, therefore, ultimately responsible for preventing Lone Star from realizing the full value of its investment.

**3. Resentment Against Foreign Investment Builds in Korea’s Post-Crisis
Political Culture**

63. For historical reasons, a large segment of the Korean population has always resented foreign intervention in Korea. Many Koreans believe that foreigners do not act in the greater interests of Korea and seek only to plunder Korea of its wealth. According to Evan Ramstad, who was based in Seoul for seven years as a reporter for the Wall Street Journal, There is a common belief in Korea “that fundamental businesses in Korea, banking and infrastructure and agriculture to name a few, should be conducted by Koreans for Koreans. Ultimately, this has come to mean that any profits made in Korea should stay there.”⁵⁸ It was this attitude that prompted much of the hostility to Lone Star’s attempts to sell its shares in KEB and remit the proceeds out of Korea.

64. Tami Overby, the former head of the American Chamber of Commerce in Seoul, explains:

Korea has endured more than 900 foreign invasions, which has given many Koreans a heightened sense of suspicion and antipathy toward foreigners. As a result, Koreans can often be hostile to foreign entities, particularly if there is a public perception that such entities may earn what Koreans view as an unacceptably high profit, which can lead to a distorted view of normal commercial behavior. What many outside Korea would view as legitimate profit-taking, many segments of the Korean public would view as plundering. This type of attitude is pervasive in Korean culture, but is particularly acute with respect to the United States and U.S. companies (or, in this case, companies perceived as American) because of resentment by a segment of the Korean population over

⁵⁸ Witness Statement of Evan Ramstad (“Ramstad Witness Statement”) at para. 3 [Exhibit CWE-005].

the influence that the United States is perceived to wield within the country.⁵⁹

65. The 1997 crisis intensified Koreans' inherent suspicions of foreign intervention. The crisis, together with the grueling period of reforms that followed, left an indelible impression on the national psyche. Koreans took great pride in the strides their country had made since the 1950s, and many Koreans were highly skeptical of the IMF bailout.⁶⁰ While the IMF viewed the crisis as a systemic problem, the result of economic and regulatory weaknesses stemming from Korea's state-led development model, Koreans believed Korea was the victim of a broader regional crisis that spread to Korea only after foreign investors mounted a speculative attack on its currency.⁶¹ Koreans felt they needed an emergency loan, not an economic overhaul, and they were resentful that the IMF conditioned the bailout upon Korea's agreeing to undertake economic reform.

66. Many Koreans felt the IMF's reform program had exacerbated the effects of the crisis. Rather than shoring up confidence in the market, Koreans believed that the IMF's retrenchment program actually *contributed* to investor panic by signaling the beginning of a severe economic contraction while at the same time giving investors more freedom to withdraw their money.⁶² Critics stressed the social costs of the IMF reforms, citing mass layoffs and the growing percentage of the population living in poverty in post-crisis Korea—a figure that rose steadily from 3.1% in 1996 to 8.2% in 2000 and to 11.6% in 2006.⁶³

⁵⁹ Witness Statement of Tami Overby ("Overby Witness Statement") at para. 7 [Exhibit CWE-004].

⁶⁰ See Corning, *Managing the Asian Meltdown* at 5 [Exhibit C-042].

⁶¹ See Corning, *Managing the Asian Meltdown* at 5 [Exhibit C-042].

⁶² See Corning, *Managing the Asian Meltdown* at 6 [Exhibit C-042].

⁶³ See Heung-seek Cho, *People's Action and Solidarity Challenging Globalisation*, ASEM 2000 People's Forum, October 17-21, 2000, at 2 [Exhibit C-321].

67. Criticism directed toward the IMF was often bound up with anti-American hostility, and specifically with the perception that the IMF's bailout conditions closely tracked Washington's foreign policy agenda with respect to Korea.⁶⁴ The IMF struck a nerve, and, as discussed in further detail below, it was that same anti-foreign nerve that Lone Star struck when it tried to sell its investment in KEB at a large profit (and without paying Korean taxes), and it was that same resentment that Lone Star's critics were appealing to when they portrayed the firm as a foreigner ransacking Korea's wealth. Indeed, according to Mr. Ramstad, the dispute at issue in this arbitration cannot be divorced from the broader political, economic, and cultural environment in Korea.⁶⁵

4. On the Verge of Insolvency, Korea Exchange Bank Seeks an Injection of Foreign Capital

68. The intense animosity many Koreans later developed toward Lone Star was heightened by the fact that Lone Star acquired and then sought to sell control of what was perhaps the most prestigious bank in Korea, KEB.

69. KEB was established in 1967 as a state-owned financial institution.⁶⁶ Spun off from the Bank of Korea ("BOK") (the country's central bank), it was chartered as a foreign exchange bank and initially authorized to engage only in foreign exchange and international trade finance.⁶⁷ For years, people knew KEB as the only bank where one could go to remit or

⁶⁴ See Corning, *Managing the Asian Meltdown* at 7-8 [Exhibit C-042].

⁶⁵ Ramstad Witness Statement at para. 2 [Exhibit CWE-005].

⁶⁶ See Project Orion, Information Memorandum, April 2010, at 16 [Exhibit C-221].

⁶⁷ See Robert Fallon, *Korea's Financial Evolution: A Banker's Perspective*, APEC Study Center, February 28, 2005 ("Fallon, *Korea's Financial Evolution*"), at 7 (noting that KEB's "actual name in Korean translates as 'foreign exchange bank.'") [Exhibit C-323].

receive foreign currency.⁶⁸ In 1989, KEB was privatized and permitted to expand its activities, and five years later the bank's shares were trading on the stock market.⁶⁹ Although KEB is now a full-service commercial bank, it has maintained its leading position in foreign exchange and trade finance.⁷⁰

a. KEB During the 1997 Crisis

70. A former state-owned bank, KEB was an active participant in the state-directed lending that drove Korea's manufacturing boom and consequently was both closely aligned with the Korean government and substantially exposed to the *chaebol*.⁷¹ However, although the 1997 crisis took its toll on KEB, the bank was neither nationalized nor forced to merge during the restructuring period. Instead, KEB relied on capital injections from other financial institutions to shore up its capital reserves during the darkest months of the crisis and recovery period.⁷²

71. During the 1997 crisis, KEB's deteriorating capital position forced the bank to undergo a protracted period of financial restructuring. By the end of 1997, KEB's BIS ratio⁷³ had fallen below the required 8% minimum, prompting the FSC in February 1998 to issue a management-improvement recommendation.⁷⁴ The recommendation functioned like a

⁶⁸ See Fallon, *Korea's Financial Evolution* at 7 [Exhibit C-323].

⁶⁹ See Fallon, *Korea's Financial Evolution* at 11 [Exhibit C-323].

⁷⁰ See Witness Statement of Richard Wacker ("Wacker Witness Statement") at para. 20 [Exhibit CWE-008].

⁷¹ See Fallon, *Korea's Financial Evolution* at 11-12 [Exhibit C-323].

⁷² See Byeon Decision at 91-92 [Exhibit C-208].

⁷³ A key indicator of bank solvency, the "BIS" (or Bank of International Settlements) ratio provides the ratio between risk-bearing capital and risk-weighted assets.

⁷⁴ See Byeon Decision at 92 [Exhibit C-208]. After the issuance of the recommendation, KEB was required to submit a management-improvement plan to the FSC for approval. Byeon Decision at 91. Upon approval of the management-improvement plan, KEB was required to implement such plan within the requisite period and the FSC monitored KEB's implementation progress. If the FSC had refused to approve the plan, KEB would have been at risk of being subject to more severe measures.

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probationary period: KEB management had one year to restructure and reorganize the bank.⁷⁵ If after that period the bank's financial condition had not improved, the regulator had the authority to take more drastic measures, including forcing a merger or closure.⁷⁶

72. In response to this measure, in July 1998, KEB entered into a strategic partnership with Germany's Commerzbank, which, over the course of the next two years, would invest approximately \$800 million in KEB.⁷⁷ KEB also received investments from the Korean government through the state-owned Export-Import Bank of Korea ("KEXIM"), which invested KRW 0.8 trillion between 1999 and 2000.⁷⁸ Between KEXIM (32.5%) and the BOK (10.67%), the Korean government owned nearly half of the bank as of 2000.⁷⁹ Commerzbank was the second largest shareholder (32.5%),⁸⁰ and the rest of the bank's shares (24.3%) were publicly traded.

73. In recognition of KEB's progress, the FSC removed the management-improvement recommendation in April 2002—but not before cautioning that KEB had not fully recovered, that the bank would need to take prompt action to correct its weak capital position, and that it would have to do so without resorting to public funds.⁸¹ Indeed, despite the financial

⁷⁵ See Byeon Decision at 91-92 [Exhibit C-208]. The initial one-year period was subsequently extended.

⁷⁶ See Yoo, *THE INCONVENIENT TRUTH* at 25 [Exhibit C-286].

⁷⁷ See Investment Agreement between KEB and Commerzbank," MOFE Press Release, May 28, 1998 [Exhibit C-035]; Project Knight Equity Co-investment Memorandum, July 22, 2003, at 4 ("Project Knight Memorandum") [Exhibit C-049]; Fallon, *Korea's Financial Evolution* at 7 [Exhibit C-323].

⁷⁸ See Project Orion, Information Memorandum at 16 [Exhibit C-221]; Byeon Decision at 98 [Exhibit C-208]; "BOK's Investment in KEXIM and KEXIM's Investment in KEB," MOFE Press Release, April 19, 1999 [Exhibit C-319].

⁷⁹ See Byeon Decision at 92 [Exhibit C-208].

⁸⁰ B See yeon Decision at 92 [Exhibit C-208].

⁸¹ See "Bank Business Management Evaluation Committee's Standards for Evaluation," FSC Press Release, November 8, 2000 at 1-5 (addressing criteria for determining whether and under what circumstances an improvement order can be lifted) [Exhibit C-045]; White Paper, Public Funds Report, 2003 at 211 [Exhibit C-315].

support that it had received from Commerzbank and KEXIM, and despite having set aside more than \$3.2 billion over the previous five years as allowances for bad loans, the bank was still experiencing losses from legacy credit exposure to the *chaebol*.⁸²

74. During the 1997 crisis, KEB experienced difficulties due to its position as the lead creditor to the former Hyundai Group and its substantial exposure to other large conglomerates.⁸³ SK Global, Hynix Semiconductor (“Hynix”), Hyundai Engineering & Construction, and Daewoo Group all had defaulted on KEB loans.⁸⁴ But KEB’s relationship with Hynix, then the world’s third largest producer of computer memory chips, proved especially damaging.⁸⁵ By 2002, due to a sharp decline in global demand for computer memory chips, Hynix was “virtually bankrupt.”⁸⁶ When it became clear that Hynix was on the verge of default, the company’s creditors intervened with a series of rescue packages that allowed Hynix to restructure its debt—then totaling approximately KRW 8.6 trillion—and avoid bankruptcy.⁸⁷ As one of Hynix’s largest creditors, KEB suffered significant losses from the Hynix rescue, including a costly debt-equity swap in 2003 that imperiled the bank’s capital position and ultimately set the stage for Lone Star’s investment.

75. As discussed below, KEB had also been hit hard by a consumer credit crisis, a follow-on to the 1997 financial crisis resulting from a short-sighted attempt to stimulate

⁸² See Project Knight Memorandum at 4 [Exhibit C-049].

⁸³ See Presentation of Lone Star Funds to U.S. Federal Reserve Board, August 19, 2003, at 45 (“Presentation to Federal Reserve Board”) [Exhibit C-050].

⁸⁴ See Presentation to Federal Reserve Board at 45 [Exhibit C-050].

⁸⁵ See *Hynix Semiconductor: The Largest and Most Successful Asian Corporate Restructuring Ever*, Report by APEC Study Center, September 23, 2008, at 3 (“*Hynix Semiconductor*, APEC Report”) [Exhibit C-207].

⁸⁶ See *Hynix Semiconductor*, APEC Report at 3 [Exhibit C-207].

⁸⁷ See *Hynix Semiconductor*, APEC Report at 3-4 [Exhibit C-207].

consumer spending by easing consumer credit standards.⁸⁸ By the end of 2002, KEB's BIS ratio was only 9.31%—perhaps not a dire figure, but still one of the lowest among Korea's commercial banks,⁸⁹ and a sign that KEB could ill afford the shock of any unexpected liquidity crunch.⁹⁰

b. KEB Tries to Shore Up Its Capital Position

76. As directed by the FSC, KEB began seeking out new sources of capital. The bank entertained the idea of raising capital through a public share offering, but the plan was foiled when the bank's stock price began to decline in the second half of 2002.⁹¹ KEB considered issuing corporate bonds, but that plan, too, was scrapped in the absence of willing buyers.⁹² Moreover, in contrast with most other commercial banks in Korea, KEB was not as of 2002 considered “insolvent” under Korean law,⁹³ and therefore was not eligible for public funding from the Korean government.⁹⁴ (By the time the bank's capital position became more desperate in 2003, such public funds were no longer available.⁹⁵)

⁸⁸ See Ul.c. Heo et al., *The Political Economy of South Korea: Economic Growth, Democratization, and Financial Crisis*, CONTEMPORARY ASIAN STUDY SERIES 20 (2008) (“Heo, *Political Economy of South Korea*”) [Exhibit C-174].

⁸⁹ See Byeon Decision at 124 [Exhibit C-208]; Yoo, *THE INCONVENIENT TRUTH* at 44 [Exhibit C-286].

⁹⁰ See Byeon Decision at 124 [Exhibit C-208]; Expert Opinion of Guy Miller at para. 3.1.1 (“Miller Expert Opinion”) (critiquing KEB CEO's admission that the bank's capital position was ‘relatively weak’) [Exhibit CWE-013].

⁹¹ See Byeon Decision at 94-95 [Exhibit C-208].

⁹² See Byeon Decision at 96 [Exhibit C-208].

⁹³ See The Act on the Structural Improvement of the Financial Industry (Law No. 6,807, December 26, 2002) [Exhibit CA-106].

⁹⁴ See White Paper, Public Funds Report, 2003, at 211 [Exhibit C-315]; “Evaluation and Measures,” FSC press release, November 8, 2000, at 4 [Exhibit C-046].

⁹⁵ As of late 2003, the total amount of public funds available had shrunk to KRW 3.7 trillion in total. White Paper, Public Funds Report, 2003 at 9-10 [Exhibit C-315]. See also Minutes of the National Assembly, Finance and Economy Committee, Inspection on National Economy Advisory Council, October 10, 2005 [Exhibit C-097].

77. KEB could not turn to its largest shareholders, KEXIM and Commerzbank. KEXIM was under political pressure not to invest,⁹⁶ and Commerzbank was itself struggling financially and not in a position to make further investments in KEB.⁹⁷ With the exception of Korea First Bank, which had just received a capital injection from Newbridge,⁹⁸ no other domestic bank was in any position to recapitalize KEB, and due to its weak financial condition, KEB could not obtain capital from the public markets without paying dearly.⁹⁹ KEB eventually hired Morgan Stanley to find a suitor, but no strategic investors—not Bank One, BNP Paribas, Citigroup, Credit Suisse, HSBC, JP Morgan, Newbridge, or Standard Chartered Bank—were interested.¹⁰⁰

78. KEB was quickly running out of options. Although technically in compliance with the required BIS ratio, KEB had a weak capital base that made it inadequately reserved for losses, and the bank's own assessment was that its capital adequacy would fall below the required ratio if it properly accounted for its asset impairments, including its credit exposure to Hynix, SK Global, and KEB Card.¹⁰¹ Without a capital injection, the bank ran the risk of regulatory intervention. Intervention by the government was a real possibility, and almost certainly KEB would fall behind its competitors in Korea's banking sector.¹⁰² Highlighting the bank's precarious position, Moody's assigned KEB an E+ rating for financial strength, virtually

⁹⁶ Byeon Decision at 252 [Exhibit C-208].

⁹⁷ Byeon Decision at 252 [Exhibit C-208].

⁹⁸ KFB entertained the idea of a merger with KEB but ultimately decided it against it. *See* "Distribution of Explanatory Material on KEB," MOFE Press Release, June 20, 2006 [Exhibit C-331].

⁹⁹ Project Knight Memorandum at 3 [Exhibit C-049].

¹⁰⁰ Byeon Decision at 117-118 [Exhibit C-208]; Witness Statement of Ellis Short ("Short Witness Statement"), at para. 10 [Exhibit CWE-006].

¹⁰¹ Presentation to Federal Reserve Board at 46 [Exhibit C-050].

¹⁰² Witness Statement of John Grayken ("Grayken Witness Statement") at para. 13 [Exhibit CWE-002].

the lowest possible rating for a financial institution and a sign that Moody's believed the bank would soon require capital support from a third party.¹⁰³

79. According to Claimants' expert Guy Miller, an investment banker who specializes in financial institutions, by the end of 2002, "KEB was in a position of real financial weakness."¹⁰⁴ Miller points to the substantial drop in the bank's net income (KRW 113 billion, down from KRW 222.5 billion the previous year), as well as its weak capital position (the bank's BIS ratio was 9.31%, down from 10.96% the previous year and approaching the 8% regulatory minimum).¹⁰⁵

80. In March 2003, KEB told financial regulators that its condition was deteriorating: absent an injection of capital, and with further losses from its exposure to Hynix and SK Global, the bank's capital position would only get weaker.¹⁰⁶ As a worst case scenario, the bank estimated that its BIS ratio could fall to 5%.¹⁰⁷ Several months later, in July 2003, KEB forecasted a year-end BIS ratio of 6.1%, well below acceptable standards.¹⁰⁸ This forecast is consistent with the findings of Mr. Miller, who also projects that the year-end BIS ratio would

¹⁰³ Bank Atlas Chart, *Euromoney*, June 1, 2003 [Exhibit C-416]; Moody's Rating Symbols and Definitions, August 2003 [Exhibit C-417].

¹⁰⁴ Miller Expert Opinion at para. 3.1.1 [Exhibit CWE-013].

¹⁰⁵ Miller Expert Opinion at para. 3.1.1 [Exhibit CWE-013].

¹⁰⁶ Byeon Decision at 126 [Exhibit C-208].

¹⁰⁷ National Assembly Minutes, October 10, 2005 (Dr. Byeon testified: "Lone Star brought in KRW 1.4 trillion of foreign capital and KRW 1.1 trillion was injected into KEB in the form of new stocks. That's how KEB's BIS ratio reached nine-point-something percent at the end of 2003. Without the funds, they say, the ratio would have been 4.4%. How can you even call a bank with 4.4% of BIS ratio a bank? If we said 'no' to Lone Star when it offered capital, KEB would have faced such risk.") [Exhibit C-097].

¹⁰⁸ Byeon Decision at 213-14 [Exhibit C-208]; Board of Audit and Inspection of Korea, Report on Sale of Korea Exchange Bank: Summary of Audit Result, March 2007 ("BAI Report on Sale of KEB") [Exhibit C-152]; The BAI would later conclude that the 6.16% figure was incorrect. "Explanation on the Media Report Made by KBS Special - In Depth Report on Secrets Behind the KEB Sale," FSS Press Release, March 20, 2006 [Exhibit C-111]; "Explanation on the Course of Preparation of Report on 'Status of Management and Guidance Plan'," FSS Press Release, April 11, 2006 [Exhibit C-117].

have been 6.1% were it not for Lone Star's investment.¹⁰⁹ The government has since acknowledged that, had KEB been unable to obtain capital, the BIS ratio would have fallen to 4.4%, with a high probability that the bank would have become insolvent.¹¹⁰

B. LONE STAR RESCUES KEB

81. In the fall of 2003, Lone Star, through Claimant LSF-KEB, purchased a majority stake in KEB.¹¹¹ The KEB acquisition was at that point the largest single investment in Lone Star's history—the culmination of a half decade of investing in Korea during which Lone Star had developed a strong relationship with the Korean government and built a reputation as a responsible asset manager.

82. This Section provides the history of Lone Star's operations in Korea, beginning with its participation in Korea's post-crisis restructuring process and leading up to LSF-KEB's acquisition of a majority stake in KEB. As explained below, Lone Star had a strong track record of investing in distressed assets in Korea and around the world, and in particular had experience investing in, and turning around, troubled banks. Given its resources, expertise and track record, and based on its assessment of KEB, Lone Star was willing to undertake the massive \$1 billion investment necessary to recapitalize KEB, with all of the risk entailed in that endeavour. The nature of Lone Star's business was well known and, in line with its business model, Lone Star

¹⁰⁹ Miller Expert Opinion at para. 6.1.2 [Exhibit CWE-013].

¹¹⁰ “[Testimony of] Director General of Financial Policy Bureau at the Ministry of Finance and Economy,” Minutes of National Assembly Finance and Economy Committee Inspection on National Economy Advisory Council, October 10, 2005 [Exhibit C-097]; John Grayken Press Conference, May 23, 2006 [Exhibit C-129]; *see also* “KEB Interview,” *Money Today*, February 19, 2006 [Exhibit C-107].

¹¹¹ Share Purchase Agreement between Lone Star Fund IV (U.S.), L.P. and Commerzbank AG and Export-Import Bank of Korea, August 27, 2003 (“Share Purchase Agreement”) [Exhibit C-026]; Share Subscription Agreement between Lone Star Fund IV (U.S.), L.P. and Korea Exchange Bank, August 27, 2003 (“Share Subscription Agreement”) [Exhibit C-052]; Assignment Agreement between Lone Star Fund IV (U.S.), L.P. and LSF-KEB Holdings SCA, September 5, 2003 [Exhibit C-379].

intended to sell KEB at a profit once the bank had returned to profitability. Korea nevertheless encouraged the investment in order to save the bank from insolvency.

1. Lone Star's Successful History in East Asia

83. Lone Star is a private equity firm that invests in distressed assets in markets that have experienced economic turmoil. Those distressed assets may take many forms, including, for example, non-performing loan (“NPL”) portfolios or companies facing bankruptcy.¹¹² When a private equity firm such as Lone Star invests in a distressed company, the purpose is to restore good management and profitability to that company, and then sell the company for a profit. Such investments often rescue the company from bankruptcy and save the jobs of the workers. Investment in distressed assets is inherently risky, and for taking on that risk with a substantial investment, the private equity fund often (but not always) earns a high return. That is the very nature of the business model.

84. Since establishing its first fund in 1995, Lone Star has organized twelve private equity funds that invest on behalf of institutional investors like pension funds, university endowments, and sovereign wealth funds, including the IMF and United Nations pension funds.¹¹³ The funds are closed-end, which means that they raise a prescribed amount of capital to be invested only once, with the proceeds from the investments returned to the investors as the assets are liquidated.¹¹⁴

85. Lone Star came to Korea by invitation. In response to the 1997 financial crisis, the Korea Asset Management Corporation (“KAMCO”) had spent billions of dollars purchasing

¹¹² Grayken Witness Statement at para. 1 [Exhibit CWE-002].

¹¹³ Grayken Witness Statement at para. 1 [Exhibit CWE-002].

¹¹⁴ Witness Statement of Michael Thomson (“Thomson Witness Statement”) at 15 [Exhibit CWE-007].

NPLs from Korean banks, and it was actively seeking foreign investors willing to invest in distressed debt (such as NPLs).¹¹⁵ Lone Star successfully participated in KAMCO's original 1998 debt auction, and over the next several years it continued to purchase pools of debt from KAMCO as well as from financial institutions directly, becoming an active participant in the country's restructuring process.¹¹⁶ Lone Star also made several large investments in the real estate industry, including the June 2001 purchase (through a Korean company named Star Tower Corporation ("STC")) of what would become the largest office tower in Korea, the 2002 purchase of a struggling lease finance company (Star Leasing & Finance Co., Ltd. ("Star Lease")), and the 2003 purchase of a commercial construction company (Kukdong Engineering and Construction Co., Ltd. ("Kukdong")).¹¹⁷ By 2003, Lone Star was Korea's largest foreign investor, having acquired assets and operating companies totaling approximately KRW 7 trillion in book value.¹¹⁸

86. In the meantime, Lone Star had formed (i) Lone Star Advisors Korea, L.L.C. ("LSAK"), a wholly owned subsidiary of Lone Star's global origination company, to originate (*i.e.*, identify and advise on the acquisition of) its Korea-based investments; and (ii) Hudson Advisors Korea, Inc. ("HAK"), a subsidiary of Lone Star's affiliated asset management company based in Texas, to handle the underwriting, managing, restructuring, and servicing of Lone Star's Korea-based assets.¹¹⁹

¹¹⁵ Grayken Witness Statement at para. 7 [Exhibit CWE-002].

¹¹⁶ Grayken Witness Statement at paras. 8-9 [Exhibit CWE-002].

¹¹⁷ Grayken Witness Statement at para. 9 [Exhibit CWE-002].

¹¹⁸ *See* Presentation to Federal Reserve Board at 11 [Exhibit C-050].

¹¹⁹ Grayken Witness Statement at para. 8 [Exhibit CWE-002].

87. In 2002, Lone Star began considering investments in distressed Korean banks,¹²⁰ and pursued the acquisition of Seoul Bank, a Korean commercial bank that had been nationalized in the wake of the financial crisis.¹²¹ Lone Star was an attractive candidate for the deal. Not only was the firm an active Korean investor in good standing with the Korean government, but it had recently purchased a similarly situated institution in Tokyo Sowa Bank, a failed Japanese bank that had been nationalized by the Japanese government.¹²² Under Lone Star's stewardship, Tokyo Sowa (renamed Tokyo Star Bank) strengthened its capital position and rationalized its branch structure and product offerings, and quickly became one of the healthiest financial institutions in Japan.¹²³ Lone Star's positive experience with Tokyo Sowa lent credibility to its bid for Seoul Bank, and the government selected Lone Star as one of three finalists for onsite due diligence.¹²⁴ Although the government ultimately chose Hana Bank, Lone Star emerged from the Seoul Bank auction with a positive relationship with the Korean financial regulators.¹²⁵

2. Lone Star Agrees to Invest More Than \$1 Billion in KEB

88. By fall 2002, KEB was widely known to be in financial trouble, and it was around this time that Lone Star first learned that the Korean government was seeking investors for KEB.¹²⁶ As noted, KEB was one of the few commercial banks that had not been closed, merged, or effectively nationalized through the infusion of public funds in the wake of the 1997 crisis.

¹²⁰ Grayken Witness Statement at para. 10 [Exhibit CWE-002].

¹²¹ Presentation to Federal Reserve Board at 60 [Exhibit C-050].

¹²² Presentation to Federal Reserve Board at 60 [Exhibit C-050].

¹²³ Presentation to Federal Reserve Board at 26-28. [Exhibit C-050]; Short Witness Statement at para. 8 [Exhibit CWE-006].

¹²⁴ Grayken Witness Statement at para. 11 [Exhibit CWE-002].

¹²⁵ Grayken Witness Statement at para. 11 [Exhibit CWE-002].

¹²⁶ Byeon Decision at para. 100 [Exhibit C-208]; Thomson Witness Statement at para. 9 [Exhibit CWE-007]; Short Witness Statement at para. 9 [Exhibit CWE-006].

KEB was able to avoid this fate thanks to KEXIM and Commerzbank, which together between 1999 and 2002 poured more than \$1.5 billion into the bank. Still, KEB had performed poorly since the financial crisis, and it was continuing to experience high loan losses and erosion of its capital base.¹²⁷ It was against this backdrop that Dr. Yang-ho Byeon, the Director General of Financial Policy at the Ministry of Finance and Economy (“MOFE”), met with Lone Star.¹²⁸

89. Under these circumstances, Lone Star had emerged as a rare suitor to purchase KEB. Strategic investors will typically shy away from distressed banks unless the government is willing to assume the risk of nonperforming assets, as the Korean government did when Newbridge acquired KFB.¹²⁹ Companies like Merrill Lynch, Morgan Stanley, and Lehman Brothers were investing in Korea at the time, but only in real estate and industrial companies. They seemed to have no appetite for a commercial bank.¹³⁰ On the other hand, while distressed-asset buyers are generally daunted by the complexity of operating a commercial bank, Lone Star had experience acquiring and turning around a troubled bank (Tokyo Sowa)¹³¹ and was well suited to appraise and manage KEB’s \$50 billion of assets.¹³²

90. Lone Star conducted due diligence between late 2002 and the summer of 2003.¹³³ In April 2003, Lone Star entered into a Memorandum of Understanding with KEB that set forth the terms of a potential agreement and allowed Lone Star to continue to conduct due diligence.¹³⁴

¹²⁷ Short Witness Statement at para. 9 [Exhibit CWE-006].

¹²⁸ Byeon Decision at para. 100 [Exhibit C-208].

¹²⁹ Grayken Witness Statement at para. 14 [Exhibit CWE-002].

¹³⁰ Short Witness Statement at para. 10 [Exhibit CWE-006].

¹³¹ Short Witness Statement at para. 8 [Exhibit CWE-006].

¹³² Grayken Witness Statement at para. 13 [Exhibit CWE-002].

¹³³ Thomson Witness Statement at para. 10 [Exhibit CWE-007].

¹³⁴ Short Witness Statement at para. 11 [Exhibit CWE-006].

Lone Star retained a team of consultants and accountants to review the bank's financial condition.¹³⁵ Following an extensive review, Lone Star confirmed that KEB, although it was in a capital crisis, was a fundamentally solid institution with considerable upside.¹³⁶ Although the bank had been weakened by poor lending decisions, it had a strong franchise and was well positioned in strategic fee-based sectors such as trade finance and foreign exchange.¹³⁷

91. While Lone Star was conducting due diligence, it was also negotiating with KEB's main shareholders—Commerzbank and, through KEXIM and BOK, the Korean government. The negotiations culminated on August 27, 2003, when the parties entered into a full set of investment agreements: a share subscription agreement between Lone Star and KEB, and share purchase agreements between Lone Star and KEB's major shareholders, Commerzbank and KEXIM. Under these agreements, Lone Star agreed to acquire (i) 268,750,000 newly issued KEB common shares for KRW 1.075 trillion (\$934 million), and (ii) 57,101,715 preferred shares from Commerzbank and KEXIM for KRW 308.4 billion (\$236 million).¹³⁸ In addition, Lone Star obtained an option to acquire an additional 90,898,285 preferred shares from Commerzbank and KEXIM at a later time.¹³⁹ All told, LSF-KEB, the company established to make Lone Star's investment, would hold 51% of the outstanding shares

¹³⁵ Lone Star obtained Citigroup Global Markets as financial adviser, Samjong KPMG to review KEB's balance sheet, McKinsey to assess its core operations, and HAK to review the bank's distressed debt. Short Witness Statement at para. 11 [Exhibit CWE-006].

¹³⁶ Project Knight Memorandum at 4 [Exhibit C-049].

¹³⁷ Project Knight Memorandum at 4 [Exhibit C-049].

¹³⁸ Share Subscription Agreement Between Lone Star Fund IV (U.S.), LP and Korea Exchange Bank, August 27, 2003 ("Share Subscription Agreement") at 5 [Exhibit C-052]; Share Purchase Agreement between Lone Star Fund IV (U.S.), L.P. and Commerzbank AG and Export-Import Bank of Korea, August 27, 2003 ("Share Purchase Agreement") [Exhibit C-026].

¹³⁹ Share Subscription Agreement at 5 [Exhibit C-052].

of KEB, with an option to acquire an additional 14%. (LSF-KEB exercised that option in May 2006, paying \$816 million to purchase additional shares from KEXIM and Commerzbank.¹⁴⁰)

92. Contrary to a criticism that was later voiced widely, LSF-KEB did not acquire the KEB shares at anything like a fire-sale price. LSF-KEB purchased the shares at a 55% premium over the March 2003 trading price (before the market took into account the Lone Star acquisition), and a 13% premium over the price at which KEB stock was trading immediately before the closing of the purchase.

3. The Korean Government Grants Regulatory Approval of Lone Star's Acquisition to Ensure that KEB Remains Solvent

93. The Korean government strongly encouraged Lone Star's investment in KEB. The Korean government also pushed hard for the FSC approvals required under Korean law whenever an entity seeks to acquire a substantial stake in a commercial bank.¹⁴¹ Denying Lone Star's application for approval would have jeopardized KEB. As evidence of the government's eagerness to complete the approval process, on September 3, 2003, MOFE made an official request to the FSC to approve Lone Star's application.¹⁴² Then, on October 15, 2003 the Deputy Governor of the FSS wrote a letter to a senior regulator at the U.S. Federal Reserve Board urging him to move the U.S. approval process along.¹⁴³

94. After the signing of the share subscription and share purchase agreements, LSF-KEB and KEB worked to obtain the necessary FSC approvals. Under the Banking Act, the

¹⁴⁰ Notice to FSC Regarding LSF-KEB's Exercise of Option to Acquire Additional Shares, May 11, 2006 [Exhibit C-369].

¹⁴¹ Banking Act, Art. 15(3) [Exhibit C-048].

¹⁴² Byeon Decision at 222-23 [Exhibit C-208].

¹⁴³ Letter from Kap-su Oh to Stephen Hoffman, October 15, 2003 [Exhibit C-054].

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FSC's review of a proposed acquisition is limited to the qualifications and financial conditions of the potential buyer.¹⁴⁴ The FSC does not review the qualifications of the seller. In this regard, the Banking Act sets forth two important limitations on a potential acquirer's ability to hold shares in a commercial bank.¹⁴⁵

95. First, a non-financial business operator ("NFBO" or industrial conglomerate) is restricted from holding more than 4% of a bank's total issued and outstanding voting shares.¹⁴⁶ An industrial conglomerate is a company (or group of affiliated companies) that (i) has more than 25% of its total capital invested in companies that are not engaged in the financial sector, or (ii) has more than KRW 2 trillion invested in companies not engaged in the financial sector.¹⁴⁷ This restriction was intended to prevent the concentration of capital in large business groups such as the *chaebol*.¹⁴⁸ At the time of Lone Star's investment, it was the practice of the FSC to determine whether a potential shareholder was an NFBO based on (i) the potential shareholder's assets in Korea and (ii) any assets outside Korea that would be in the bank's direct line of ownership.¹⁴⁹

96. Second, in addition to the limitation on shareholdings by industrial conglomerates, any foreign investor seeking to purchase more than 10% of a bank must be a financial company

¹⁴⁴ Expert Opinion of Prof. Jeong-Hoon Park ("Park Expert Opinion") at paras. 20, 47-49, 55, 71 [Exhibit CWE-015].

¹⁴⁵ Banking Act, Arts. 2, 15, 16-2 [Exhibit C-048].

¹⁴⁶ Banking Act, Art. 16-2 [Exhibit C-048].

¹⁴⁷ Banking Act, Art. 2 [Exhibit C-048].

¹⁴⁸ Park Expert Opinion at para. 18 [Exhibit CWE-015].

¹⁴⁹ Statement of Opinion by Lone Star Partners IV, L.P., January 12, 2009 ("Lone Star Statement of Opinion"), at 6 [Exhibit C-210]; Thomson Witness Statement at para. 13 [Exhibit CWE-007].

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(in addition to meeting other criteria).¹⁵⁰ However, the FSC may waive this requirement for “special circumstances, such as the reorganization of a failing financial institution, etc.”¹⁵¹

97. Under the Banking Act, the FSC must process an acquiring entity’s application within 30 days.¹⁵² The review period can be extended by an additional 30 days where unavoidable circumstances necessitate, but the FSC must first provide the applicant with notice of and grounds for the delay.¹⁵³

98. On September 2, 2003, LSF-KEB filed an application with the FSC for “Excess Shareholding Approval,” *i.e.*, approval to acquire shares in KEB in excess of the prescribed limits in the Banking Act.¹⁵⁴ LSF-KEB representatives worked closely with Korean regulators to ensure that the application included all relevant materials and covered all relevant topics.¹⁵⁵ The FSC determined that the two requirements described above did not bar Lone Star’s acquisition.

¹⁵⁰ Banking Act, Art. 15(5) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 17,717 August 21, 2002), Art. 5 [Exhibit C-304]; Baik Expert Opinion at para. 52 [Exhibit CWE-009]; Park Expert Opinion at para. 46 [Exhibit CWE-015].

¹⁵¹ Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 17,717 August 21, 2002), Art. 8(2) [Exhibit C-304].

¹⁵² Banking Act, Art. 15(4) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 17,717 August 21, 2002), Art. 4-3 [Exhibit C-304]; Park Expert Opinion at para. 57 [Exhibit CWE-015]; Baik Expert Opinion at para. 54 [Exhibit CWE-009].

¹⁵³ Banking Act, Art. 15(4) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 17,717 August 21, 2002), Art. 4-3 [Exhibit C-304]; Administrative Procedures Act of Korea (Law No. 5241, December 31, 1996), Art. 19 [Exhibit C-310]; Park Expert Opinion at para. 56 [Exhibit CWE-015].

¹⁵⁴ Financial Supervisory Commission, Approval of Shares of Korea Exchange Bank, September 26, 2003 (referencing September 2, 2003 application) [Exhibit C-053]; *see* Banking Act, Art. 15(3) [Exhibit C-048].

¹⁵⁵ Lone Star’s Statement of Opinion at 6 [Exhibit C-210].

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99. The FSC determined that KEB satisfied the “special circumstances” exception described above, and so allowed LSF-KEB to own more than 10% of KEB.¹⁵⁶ The FSC also determined that LSF-KEB was not an industrial conglomerate.¹⁵⁷ As discussed in Section III.I, however, years later, under pressure from civic groups and the National Assembly, the FSC considered retroactively applying a new test to Lone Star based on whether Lone Star’s *global* assets qualified the company as an industrial conglomerate.¹⁵⁸ Although the FSC ultimately found that Lone Star was not an industrial conglomerate, as discussed in Section III.I, the exercise took years to resolve and was nothing more than a transparent attempt to cast doubt on the validity of LSF-KEB’s acquisition of KEB.

100. On September 26, 2003 (within the 30-day period set out in the Banking Act), the FSC approved Lone Star’s application to purchase 51% of KEB.¹⁵⁹ One month later, on October 31, 2003, the deal closed and LSF-KEB acquired a 51% stake in KEB by injecting KRW 1.075 trillion of new capital into the bank and purchasing KRW 308.4 billion worth of existing shares from Commerzbank and KEXIM.¹⁶⁰

¹⁵⁶ Financial Supervisory Commission, Approval of Shares of Korea Exchange Bank, September 26, 2003 [Exhibit C-053].

¹⁵⁷ Financial Supervisory Commission, Approval of Shares of Korea Exchange Bank, September 26, 2003 [Exhibit C-053].

¹⁵⁸ See Statement of Facts, Sec. III.I.

¹⁵⁹ Financial Supervisory Commission, Approval of Shares of Korea Exchange Bank, September 26, 2003 [Exhibit C-053].

¹⁶⁰ Share Subscription Agreement [Exhibit C-052]; Share Purchase Agreement [Exhibit C-026].

4. KEB Immediately Regains Its Financial Footing as a Result of Lone Star's Investment

101. Under the new Shareholders Agreement, LSF-KEB was entitled to appoint five of the nine directors on KEB's board.¹⁶¹ LSF-KEB nominated Messrs. John Grayken, Ellis Short, Michael Thomson, Paul Yoo,¹⁶² and Steven Lee.¹⁶³ Mr. Steven Lee was Lone Star's senior executive in Korea, responsible for overseeing the firm's Korean investment activities.¹⁶⁴ Mr. Paul Yoo was second in command and head of LSAK, Lone Star's origination-services affiliate in Korea.¹⁶⁵ At that time KEB had four other directors: Mr. DY Lee (KEB's Acting President), Mr. Klaus Patig (nominated by Commerzbank), Mr. Hee-sun Yoo (nominated by KEXIM), and Mr. Soo-gil Lee (nominated by the BOK).¹⁶⁶

102. The acquisition immediately resolved KEB's capital problems, and Standard & Poor's upgraded KEB's credit rating to BB+ from BB, citing KEB's dramatically improved Tier 1 capital ratio.¹⁶⁷ With a stronger balance sheet, KEB was able to expedite the process of cleaning up NPLs and take other steps to put the bank on a solid financial footing.¹⁶⁸

¹⁶¹ KEB Shareholders Agreement, October 31, 2003 [Exhibit C-055].

¹⁶² Mr. Paul Yoo was also known and identified in some documents by his Korean name, Hoe-won Yoo.

¹⁶³ See Minutes of 23rd Board of Directors Meeting for 37th Fiscal Year, November 17, 2003 ("Minutes of 23rd Board of Directors Meeting") (identifying the KEB directors present and absent at the November 17 meeting of the KEB Board) [Exhibit C-058].

¹⁶⁴ Thomson Witness Statement at para. 14 [Exhibit CWE-007].

¹⁶⁵ Thomson Witness Statement at para. 14 [Exhibit CWE-007].

¹⁶⁶ See Minutes of 2nd Board of Directors Meeting, at 1 (identifying the KEB directors present and absent at the November 17 meeting of the KEB Board) [Exhibit C-058].

¹⁶⁷ KEB Credit Rating Chart [Exhibit C-319]; "Tier 1 capital" refers to a bank's core capital, which consists primarily of common stock and other shareholder funds. Miller Expert Opinion at para. 2.1.2.1.1 [Exhibit CWE-013].

¹⁶⁸ Wacker Witness Statement at para. 20 [Exhibit CWE-008].

C. TO LONE STAR'S SURPRISE, THE KOREAN GOVERNMENT DEMANDS THAT KEB CHANNEL MUCH OF LONE STAR'S EQUITY INJECTION TO RESCUE KEB CARD

103. Lone Star's plan was to recapitalize KEB, recruit world-class management to operate the bank, and then support their efforts to clean up the bank's balance sheet and strengthen its credit and risk management policies.¹⁶⁹ Lone Star's focus was on disciplined credit and investment policies, and the firm had no appetite for the increased risk that goes along with expansion.¹⁷⁰ In other words, LSF-KEB was intent on running the bank in a commercially prudent and financially sound manner to return the bank to profitability. The Korean government would soon make it clear, however, that it expected KEB to perform in accordance with the government's wishes even if that potentially threatened the viability of the bank. The first evidence of this behavior was the government's effort to strong-arm KEB into saving the ailing credit card subsidiary of the bank, KEB Card.

104. At the time of LSF-KEB's investment, KEB held a 45% stake in KEB Card.¹⁷¹ Like all other large Korean credit card companies, KEB Card had been suffering from the consequences of loose consumer lending practices put in place to stimulate private borrowing in the wake of the 1997 financial crisis.¹⁷² KEB Card had managed to mask its poor performance by refinancing delinquent loans and accounting for them as if they were new, but there could be no question that the company had lent out far more than it was going to recover.¹⁷³

¹⁶⁹ Thomson Witness Statement at para. 19 [Exhibit CWE-007].

¹⁷⁰ Thomson Witness Statement at para. 19 [Exhibit CWE-007].

¹⁷¹ See Project Knight Memorandum at 3 [Exhibit C-049].

¹⁷² To encourage private consumption in the wake of the financial crisis, the Kim Dae-jung administration, in concert with Korea's major credit card companies, had strongly encouraged consumer borrowing through credit card usage. Heo, *The Political Economy of South Korea* at 20 [Exhibit C-174].

¹⁷³ See Thomson Witness Statement at para. 20 [Exhibit CWE-007].

105. Prior to its investment in KEB, Lone Star analyzed KEB's investment in KEB Card and concluded that KEB Card would likely fail in the near term without substantial outside support, and that it would be imprudent for KEB to provide such support, given the massive losses lurking in KEB Card's balance sheet. Lone Star's due diligence team determined that the credit card company had a negative net equity of KRW 86 billion (approx. US \$72 million).¹⁷⁴

106. Because KEB Card was insolvent, and because Lone Star was convinced that KEB's investment in KEB Card would eventually be wiped out in bankruptcy, Lone Star valued KEB's equity stake in KEB Card at zero.¹⁷⁵ Moreover, Lone Star was advised by its Korean team that KEB would not suffer damages (beyond the loss of its original investment) in the likely event that KEB Card defaulted.¹⁷⁶ Based on these considerations, Lone Star concluded it would be in KEB's best interest to write off its shareholding in KEB Card and, should it come to that, let the company fail.¹⁷⁷

107. Shortly after the KEB transaction closed, KEB Card made an urgent request to KEB for liquidity support.¹⁷⁸ KEB Card was then just days away from defaulting on its obligations to creditors, and the company's management was estimating that it would require approximately KRW 1 trillion in capital by the end of the year—a sum roughly equal to the amount LSF-KEB had invested with the aim of shoring up *KEB's* balance sheet.¹⁷⁹

¹⁷⁴ See KPMG Summary Report on Agreed-Upon Procedures, August 20, 2003, at 3 [Exhibit C-051].

¹⁷⁵ Short Witness Statement at para. 15 [Exhibit CWE-006].

¹⁷⁶ Thomson Witness Statement at para. 20 [Exhibit CWE-006].

¹⁷⁷ See Project Knight Memorandum, at 8 [Exhibit C-049]; Short Witness Statement at para. 15 [Exhibit CWE-006]; Thomson Witness Statement at para. 20 [Exhibit CWE-007]; Grayken Witness Statement at para. 20 [Exhibit CWE-002].

¹⁷⁸ Fax from Un-Chul Bek, CEO of KEB Card, to President of KEB, November 15, 2003, at 1 [Exhibit C-057].

¹⁷⁹ See Fax from Un-Chul Bek, CEO of KEB Card, to President of KEB, November 15, 2003, at 2 [Exhibit C-057].

108. Lone Star and its advisors had failed to anticipate that the Korean financial regulators would demand that KEB take steps to rescue KEB Card. However, shortly after the transaction closed, Korean regulators warned KEB that they would hold the bank responsible if it let KEB Card fail, and threatened to exercise their authority to, among other things, bar the bank from entering the credit card business in the future.¹⁸⁰ Although KEB's Board of Directors ("KEB Board") opposed using the bank's newly injected capital to rescue an insolvent credit card company, facing tremendous pressure from regulators, the KEB Board ultimately authorized a rescue and subsequent merger of KEB Card into the bank.¹⁸¹ Doing so came at an extraordinarily high price—"even though KEB Card was insolvent to the tune of approximately USD 1 billion," explains former Lone Star Vice Chairman Ellis Short, "KEB had to fully repay all of KEB Card's creditors (thereby absorbing itself this USD 1 billion embedded loss), and on top of that pay KEB Card's shareholders approximately USD 150 million in cash and stock."¹⁸² On November 20, 2003, KEB's Board approved a plan to merge KEB Card into KEB.

109. After KEB announced its KEB Card merger plans, Hwa-sik Jang, head of KEB Card's union, organized a strike in protest of anticipated job cuts.¹⁸³ The union occupied the KEB Card building for weeks, preventing personnel from entering and working.¹⁸⁴ Approximately one month into the strike, on January 12, 2004, KEB confirmed rumors that KEB Card employees would be laid off as a result of the merger. In response, Jang and his union

¹⁸⁰ Thomson Witness Statement at paras. 21-22 [Exhibit CWE-006]; Short Witness Statement at para. 16 [Exhibit CWE-006].

¹⁸¹ Thomson Witness Statement at para. 21 [Exhibit CWE-006].

¹⁸² Short Witness Statement at para. 17 [Exhibit CWE-006].

¹⁸³ "Lone Star Retreats on Knife Threat in South Korean Bank Sale," *Bloomberg*, August 1, 2007 [Exhibit C-158].

¹⁸⁴ Wacker Witness Statement at para. 30 [Exhibit CWE-008].

members stormed the office of KEB Card President Joo Hoon Lee.¹⁸⁵ The group was led by union leader Hwa Sik Jang, who wielded a carving knife.¹⁸⁶ What happened next is disputed: Lee told reporters that Jang entered his office with a mob of angry workers and threatened him with a knife. Jang claimed, however, that he forced the knife into Lee's hand and held Lee's hand up to Jang's neck while shouting at Lee to cut Jang's throat before laying off KEB Card workers. Lee was hospitalized for stress as a result of the incident.¹⁸⁷

110. On February 27, 2004, the day before the merger between KEB and KEB Card was completed, the anticipated layoffs of KEB Card employees were carried out. "At that moment," Hwa-sik Jang told reporters, "I vowed that I would go all the way to get even with Lone Star."¹⁸⁸ On August 25, 2004, Jang launched Spec Watch, a civic group chartered with the aim of combating the influence of "speculative capital" on the Korean economy, with a particular focus on Lone Star.¹⁸⁹

D. KEB'S REMARKABLE TURNAROUND AFTER LONE STAR'S INVESTMENT

111. With new leadership brought in by LSF-KEB, KEB was able to overcome structural weaknesses and unfavorable market conditions and return to profitability as the financial sector as a whole recovered as well. This Section discusses measures taken by KEB's new management to improve KEB's operations and restore the bank to financial health.

¹⁸⁵ "Lone Star Retreats on Knife Threat in South Korean Bank Sale," *Bloomberg*, August 1, 2007 [Exhibit C-158].

¹⁸⁶ "Lone Star Retreats on Knife Threat in South Korean Bank Sale," *Bloomberg*, August 1, 2007 [Exhibit C-158].

¹⁸⁷ "Lone Star Retreats on Knife Threat in South Korean Bank Sale," *Bloomberg*, August 1, 2007 [Exhibit C-158].

¹⁸⁸ "Establishment of Spec Watch," Spec Watch Press Release, August 28, 2004 [Exhibit C-066].

¹⁸⁹ "Establishment of Spec Watch," Spec Watch Press Release, August 28, 2004 [Exhibit C-066].

1. KEB's New Management Takes Immediate Steps to Improve KEB's Financial Performance

112. KEB's new management undertook a multi-faceted approach to improving the bank's financial condition. The reform measures focused on (i) addressing the bank's liquidity crisis, (ii) restoring its asset quality, and (iii) improving its approach to risk management. Once implemented, these reforms combined to strengthen the bank's capital position, improve its credit rating, and set it on a course toward profitability.

a. KEB Improves Its Capital Adequacy Ratio

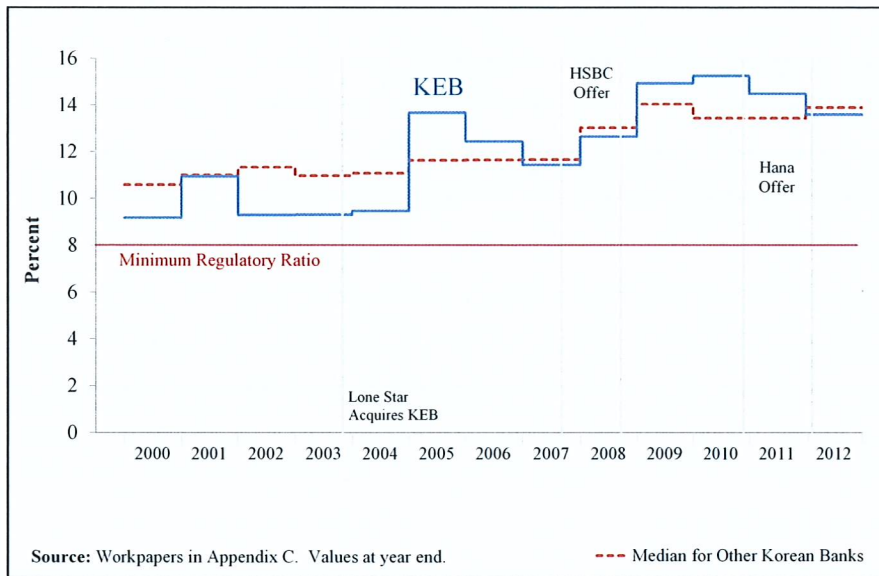
113. A strong capital adequacy ratio is the hallmark of a healthy bank. The more equity capital a bank has at its disposal, the better protected it is against unexpected losses. Under LSF-KEB's supervision, KEB brought its capital position into compliance with the FSS's prescription for Basel II guidelines,¹⁹⁰ and KEB's BIS ratio climbed to one of the highest among Korea's commercial banks.¹⁹¹

114. The following graph tracks the change in KEB's BIS ratio between 2000 and 2012 relative to the median BIS ratio of other Korean banks over the same period. Professor Stewart Myers highlights that in 2006 KEB's BIS ratio recovered from below the Korean bank median and continued about equal or above the other Korean banks' BIS median ratio between 2007 to 2011.¹⁹²

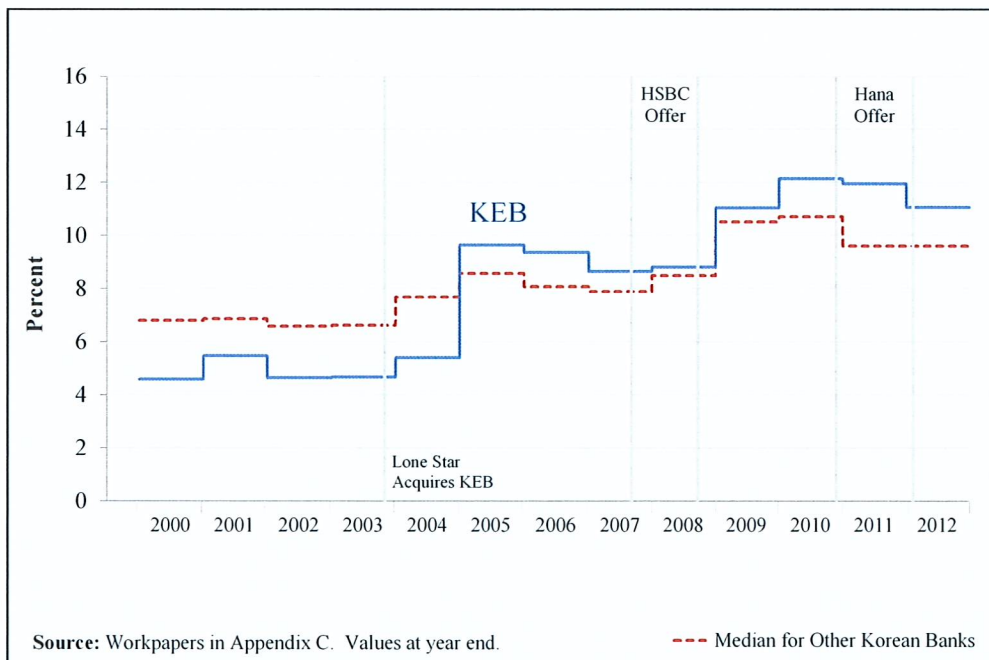
¹⁹⁰ Wacker Witness Statement at para. 17 [Exhibit CWE-008]. The Basel Accords are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. Basel II (which has since been superseded by Basel III) was the second of the Basel Accords.

¹⁹¹ Project Orion, Information Memorandum, April 2010, at 31 [Exhibit C-221].

¹⁹² Myers Expert Report at para. 23 (d), Figure 1d [Exhibit CWE-014].



115. The graph below shows significant improvement in KEB's Tier 1 ratio under LSF-KEB's ownership. As with its BIS ratio, KEB's Tier 1 capital ratio recovered in 2005 and from that point forward has matched or outpaced its peers into 2012.¹⁹³



¹⁹³ Myers Expert Report, at para. 23 (c), Figure 1c [Exhibit CWE-014].

116. Throughout the period of LSF-KEB's ownership, KEB had substantial capital cushions available for future growth, and the bank fully funded its business plan while declaring dividends in each fiscal year since 2006.¹⁹⁴ Due to its prudent lending policies, KEB was one of only two Korean banks that was not forced to raise external capital from the government during the 2008-2009 global financial crisis.¹⁹⁵

b. KEB Improves Asset Quality and Risk Management

117. A key threat to a commercial bank's profitability is the risk of losses from its lending activities.¹⁹⁶ Notwithstanding its sizeable operating income, KEB had repeatedly posted losses on a year-over-year basis in the period 1999 through 2003.¹⁹⁷ Having attributed these losses and high levels of non-performing loans to the bank's poor risk management practices, KEB's management took steps to improve these practices "by implementing many of the advanced approaches for measuring and managing bank risks under the new Basel II international standards for financial regulation."¹⁹⁸

118. KEB introduced a more disciplined approach to lending. The idea, as former CEO Richard Wacker explains, was to create risk management systems that integrate "risk information into our pricing and customer management strategies and policies to ensure that KEB was conducting business consistent with global safety and soundness principles."¹⁹⁹

¹⁹⁴ Klane Witness Statement at para. 12 [Exhibit CWE-003].

¹⁹⁵ Klane Witness Statement at para. 3 [Exhibit CWE-003]; Wacker Witness Statement at para. 11 [Exhibit CWE-008].

¹⁹⁶ Miller Expert Opinion at para. 2.1.1. [Exhibit CWE-013].

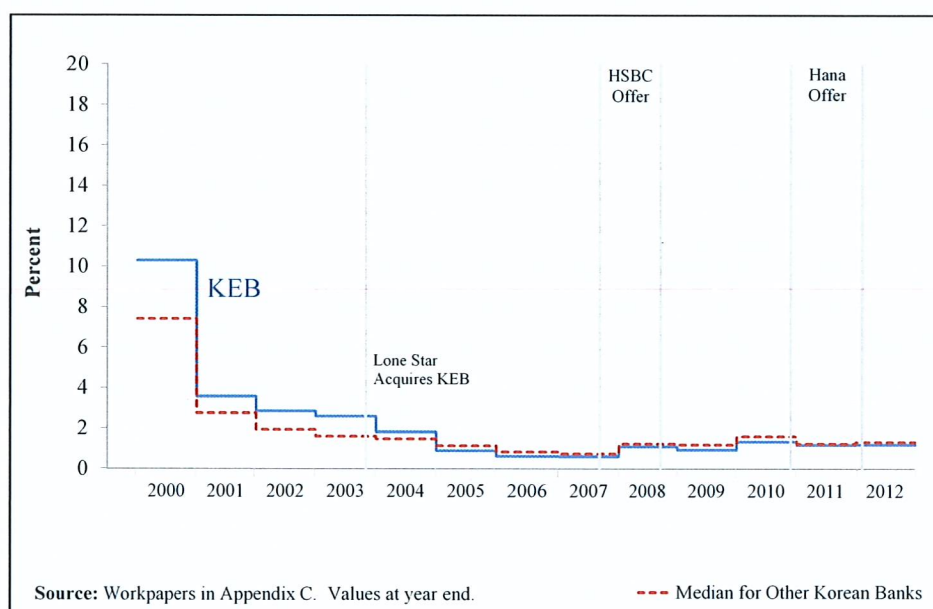
¹⁹⁷ Wacker Witness Statement at para. 10 [Exhibit CWE-008]; FSS Profitability Trends, 2000-2011 [Exhibit C-414].

¹⁹⁸ Wacker Witness Statement at para. 10 [Exhibit CWE-008].

¹⁹⁹ Wacker Witness Statement at para. 17 [Exhibit CWE-008].

119. KEB wrote off legacy NPLs and put in place lending practices designed to increase the bank's exposure to high-quality customers while limiting its exposure to risky ones.²⁰⁰ KEB thereby substantially improved the strength of its asset base. In 2009, the bank's NPL ratio, 0.94%, was the lowest in the Korean banking sector, while its 12.3% return on equity was among the strongest.²⁰¹

120. The graph below shows that KEB succeeded in steadily lowering its non-performing loan ratio to below the median of other Korean banks between 2004 and 2012.²⁰²



121. KEB also worked to restore the value of the bank's asset portfolio, conducting a careful review of its assets to determine how the bank could make the best of its corporate exposures.²⁰³ A pressing problem was KEB's stake in Hynix. When KEB's new management

²⁰⁰ Wacker Witness Statement at paras. 10, 17 [Exhibit CWE-008].

²⁰¹ Project Orion, Information Memorandum, April 2010, at 4 [Exhibit C-221].

²⁰² Myers Expert Report, at para. 23 (b), Figure 1b [Exhibit CWE-014].

²⁰³ Wacker Witness Statement at para. 13 [Exhibit CWE-008].

took over at the end of 2003, Hynix was on the verge of insolvency, leaving the value of the bank's equity position in serious jeopardy.²⁰⁴ Resolved to protect the bank's investment, KEB worked with Hynix's other major creditors in the creditors' council to oversee the company's management and restore it to financial health.²⁰⁵

122. KEB also took steps to restructure KEB Card—reducing staff to a manageable level, overhauling its credit-risk policy, and then integrating the subsidiary into the bank.²⁰⁶ KEB reduced the size of KEB Card's credit portfolio and disposed of low-quality assets.²⁰⁷ As a result of these changes, the business segment formerly known as KEB Card was returned to stability.²⁰⁸

2. KEB's New Management Makes Organizational and Structural Improvements

123. Contrary to a widely accepted view in Korea, the KEB acquisition was not a “strip and flip” scheme designed to wring KEB of short-term profits before selling it off.²⁰⁹ LSF-KEB ran the bank with an eye toward long-term growth, working tirelessly to reorganize the bank's management and investing heavily in structural and operational improvements.

124. KEB's poor financial performance was due in part to its management structure. Although the bank was privatized in 1989, it was still organized and managed like a state-run

²⁰⁴ *Hynix Semiconductor*, APEC Report at 3-4 [Exhibit C-207].

²⁰⁵ *Hynix Semiconductor*, APEC Report at 3-4 [Exhibit C-207]; Fallon, *Korea's Financial Evolution: A Banker's Perspective* at 3-4 [Exhibit C-323].

²⁰⁶ Wacker Witness Statement at paras. 6, 29 [Exhibit CWE-008].

²⁰⁷ Project Orion, Information Memorandum, April 2010, at 24 [Exhibit C-221].

²⁰⁸ Project Orion, Information Memorandum, April 2010, at 24 [Exhibit C-221].

²⁰⁹ Wacker Witness Statement at para. 56 [Exhibit CWE-008]; Grayken Witness Statement at paras. 25-26 [Exhibit CWE-002].

bank.²¹⁰ Notwithstanding years of sluggish performance, KEB's workforce had changed little since the 1997 financial crisis.²¹¹ Part of this was owing to restrictive labor laws that made it difficult to reduce the workforce. But KEB was also operating under an institutional mindset that rewarded politics and relationships over performance and made those in power highly resistant to organizational change.²¹² According to former KEB CEO Robert Fallon, who ran the bank from late 2003 until Mr. Wacker took over in 2005, "[t]he cost structure was out of control."²¹³ As Fallon explains, "Most organizations have a pyramid shape population distribution, but KEB had a big bulge in the middle. This is because people were hired year after year after year. KEB promoted everybody every year on the basis of their class, and everybody marched through the system."²¹⁴

125. Under LSF-KEB's supervision, KEB also made substantial structural and operational investments that would put the bank in a position to succeed in the fast-changing and increasingly consolidated Korean banking sector. In addition to introducing the new lending policies described earlier, KEB renovated its headquarters and two-thirds of its branches, and continued to open new branches overseas.²¹⁵ KEB also poured money into technology upgrades and new training programs, adding e-banking and mobile telephone services that improved customer access and catered to its high-net-worth clientele.²¹⁶

²¹⁰ Wacker Witness Statement at paras. 10, 24 [Exhibit CWE-008]; Fallon, *Korea's Financial Evolution: A Banker's Perspective* at 11 [Exhibit C-323].

²¹¹ Wacker Witness Statement at para. 15 [Exhibit CWE-008].

²¹² Wacker Witness Statement at para. 25 [Exhibit CWE-008].

²¹³ Fallon, *Korea's Financial Evolution: A Banker's Perspective* at 8 [Exhibit C-323].

²¹⁴ Fallon, *Korea's Financial Evolution: A Banker's Perspective* at 8 [Exhibit C-323].

²¹⁵ Wacker Witness Statement at para. 15 [Exhibit CWE-008].

²¹⁶ Project Orion, Information Memorandum, April 2010, at 15 [Exhibit C-221]; Wacker Witness Statement at para. 16-17 [Exhibit CWE-008].

3. Within Two Years, KEB's Profitability Reaches Record Levels and Outperforms Competing Korean Banks

126. As a result of these reforms, KEB's performance improved dramatically, both in absolute terms and relative to the performance of its peers. KEB had recorded substantial losses in prior years, including a KRW 1.3 trillion loss in 2003.²¹⁷ Beginning in 2004, however, the bank recorded solid profits each year, including KRW 1.9 trillion in 2005.²¹⁸ By 2009, KEB's profit (net income) of KRW 891.7 billion was roughly 14% higher than in 2008 and approximately 40% higher than it had been in 2004.²¹⁹

127. Professor Stewart Myers notes in his expert report that "[s]tock-price performance in 2005 and 2006 was exceptionally good. During this period, KEB's new top management worked to stabilize KEB and return it to normal profitability."²²⁰ Moreover, in recognition of KEB's progress, by 2007, Moody's, Fitch, and Standard & Poor's had each restored KEB's long-term credit rating to its pre-crisis level, and some of the world's most prominent financial institutions expressed interest in purchasing the bank.²²¹

128. The below graph shows the overall dynamics of KEB's stock performance between 2000 and 2013. At the time of LSF-KEB's attempts to sell its stake to HSBC, and then

²¹⁷ KEB Audited Financial Statements 2003, at 82 [Exhibit C-056]; Miller Expert Opinion at para. 5.1.2 [Exhibit CWE-013].

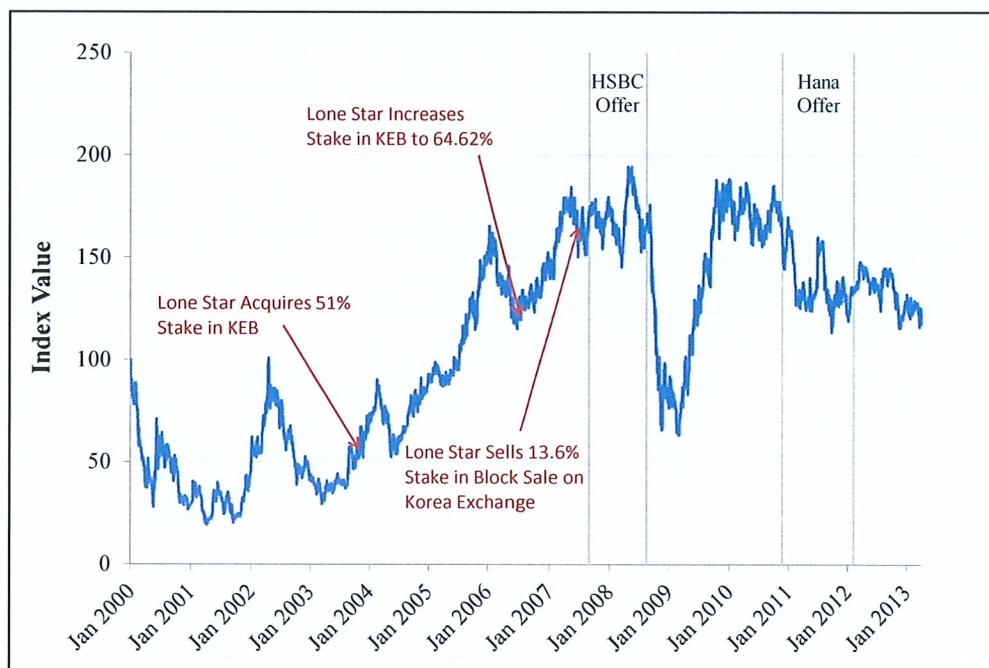
²¹⁸ KEB Audited Financial Statements 2005, at 36 [Exhibit C-375]; Deutsche Bank Analyst Report, Korea Exchange Bank Revised, 2005 at 20 [Exhibit C-091].

²¹⁹ Klane Witness Statement at para. 3 [Exhibit CWE-003].

²²⁰ Myers Expert Report at para. 33 [Exhibit CWE-014].

²²¹ Wacker Witness Statement at para. 20 [Exhibit CWE-008].

subsequently to Hana, the cumulative returns²²² on KEB's publicly traded stock were more than double those in 2003 at the time of LSF-KEB's investment.²²³



4. The Korean Government Continues to Interfere in the Operation of KEB and Hinders Reform

129. KEB's progress came in spite of regular intrusions from the Korean government. Although it had been privately operated since 1989, KEB remained aligned with the government in a way that made it especially susceptible to regulatory interference. Larry Klane, KEB's CEO from 2009 to 2012, observes that, in comparison with their counterparts in the United States and Europe, KEB's managers tended to have a less commercial mindset when interacting with regulators.²²⁴ Klane's predecessor Richard Wacker notes that KEB retained the culture and

²²² Cumulative return is a measure of common stock performance over time.

²²³ Myers Expert Report, Figure 2 [Exhibit CWE-014].

²²⁴ Klane Witness Statement at para. 6 [Exhibit CWE-003].

institutional mindset of a state-run bank.²²⁵ When Wacker first joined the bank, there was a revolving door between the bureaucracy and the Korean banks, and KEB's presidency was still viewed as a stepping stone for people who would go on to serve in senior positions within the MOFE, the FSC, and the FSS.²²⁶ This arrangement allowed regulators to use informal channels to bring pressure to bear on their peers and former colleagues in the private sector.²²⁷

130. KEB was regularly pressed to set aside its own commercial interests in favor of the government's policy goals. For instance, during the 2008-2009 global financial crisis, the government forced banks to participate in a program under which the government guaranteed banks' foreign currency debt in exchange for their agreeing to a host of costly conditions. Some of these conditions, such as mandating lending to small and medium sized enterprises, had nothing to do with foreign currency liquidity, and only served to increase credit risk at the financial institutions the regulators claimed to be trying to protect.²²⁸

131. On another occasion, in response to the 2008-2009 global financial crisis, the Korean government expected commercial banks to contribute capital to Uamco Ltd., a company established in 2009 to warehouse bank assets that had deteriorated during the crisis.²²⁹ When KEB resisted, the government exerted pressure indirectly, through the Korean Federation of Banks.²³⁰

²²⁵ Wacker Witness Statement at para. 24 [Exhibit CWE-008].

²²⁶ Wacker Witness Statement at para. 25 [Exhibit CWE-008].

²²⁷ Wacker Witness Statement at paras. 24-26 [Exhibit CWE-008].

²²⁸ Klane Witness Statement at para. 8 [Exhibit CWE-003].

²²⁹ Klane Witness Statement at para. 7 [Exhibit CWE-003].

²³⁰ Klane Witness Statement at para. 7 [Exhibit CWE-003].

132. These were only some of the day-to-day intrusions by regulators. Other examples of the government's interference with KEB's operations appear throughout this Memorial, such as the forced merger with KEB Card discussed above, which was perhaps the most egregious example of regulatory overreach. Section III.J. discusses the financial regulators' hostile response to KEB's dividend program, while Section III.I., Lone Star explains how the various government probes forced KEB's management to divert time and resources from its normal operations while impeding long-term strategic planning by creating uncertainty over the bank's next owner.²³¹

**E. FROM SAVIOR TO VILLAIN: NATIONALISM, SCANDAL-MONGERING, AND
ACTIVIST GROUPS TURN LONE STAR INTO A PUBLIC ENEMY**

133. Given that LSF-KEB had stepped in and rescued KEB, and given that KEB had become highly profitable since the time LSF-KEB had acquired a controlling interest in the bank, it would have been natural to expect that LSF-KEB would have established itself as a trusted and welcome investor in Korea. However, that was not the case. LSF-KEB's subsequent attempts to sell its interest in KEB resulted in an extraordinary public and political backlash.

134. Several factors contributed to this shift, and they all reinforced the perception widely shared among Koreans, as described above, that foreign investors who sought to make profit in Korea were seeking to "plunder" Korea of its wealth. As stated by Hee-jip Kim, country managing director of Accenture Korea in an interview with the Korea Times, "When we need money, we are very business friendly, but after they have made the investment, we certainly become a nationalistic country and hate foreign capital somehow."²³²

²³¹ Moody's Investors Service, Banking System Outlook: Korea, May 30, 2011, at 2 [Exhibit C-318].

²³² "Korea Braces for Energy Crisis," *Korea Times*, September 17, 2008 [Exhibit C-272].

135. Commentators in Korea openly acknowledged this tendency at the time the Lone Star saga was unfolding. Dr. Kihwan Kim, Chair of the Seoul Financial Forum²³³ and Korea's former Ambassador-at-large for Economic Affairs, has been a vocal critic of the treatment Lone Star received in the Korean media. In May 2008, Dr. Kim cited the Lone Star episode as the primary cause of the decline in foreign direct investment in Korea since 2004.²³⁴ In his view, "The international community thinks Koreans believe that non-Koreans making money in Korea is like committing a crime, which drives away potential foreign investors."²³⁵

136. The Lone Star saga began with a vicious public backlash inflamed by nationalist civic groups and labor unions united in resistance to "speculative" foreign investors, and a media inclined toward sensationalism and willing to take any opportunity to pour gasoline on the fire. It is difficult to overstate the intensity of the anti-Lone Star fervor. At its height, there were demonstrations in the streets, public officials on trial, and multiple press articles in every major newspaper every day.

137. As discussed in the Sections that follow, public outrage soon migrated into Korean politics, as opposition politicians and legislators in the National Assembly seized on the issue for political gain. This was quickly followed by a series of harrasing investigations and audits of Lone Star, KEB, and various government officials.

138. Ultimately, by the time Lone Star sought to sell its stake in KEB to HSBC, political controversy had hardened into an unspoken government policy, a policy of bureaucratic

²³³ The Seoul Financial Forum is a leading Korean business think tank whose members hail from some of the most prominent financial institutions in Korea.

²³⁴ "Seoul Backpedals on Financial Liberalization," *Korea Times*, May 29, 2008 [Exhibit C-335].

²³⁵ "Hub Plan Becomes Hollow Slogan," *Korea Times*, July 18, 2007 [Exhibit C-336].

paralysis in which no government official was willing to approve the application of any party seeking to acquire Lone Star's shares in KEB lest the official be tainted as assisting Lone Star in realizing the profits from its investment.

139. By the end, the Lone Star saga had sunk so deeply into the political and public consciousness that aspects of the controversy entered the Korean vernacular. The controversy itself became known as "Lone Star-gate." A prominent politician who fanned anti-Lone Star sentiment made a name for herself as the self-proclaimed "Lone Star sniper." The bureaucratic paralysis that seized FSC officials who feared for their personal and professional well-being if they allowed Lone Star to sell its shares became known as "Byeon Yang-ho syndrome," named after the public official who faced harassment, jail time, and prosecution (even though he was proven to be innocent) for his role in the original approval of Lone Star's acquisition of its shares in KEB.

140. The remainder of this Section focuses on the initial phase of the story, when public resentment first began to well up against Lone Star. This Section recounts several post-acquisition developments which help explain the source of the public outrage, including (i) the controversial exits from Korea by Newbridge and Carlyle, (ii) a 2005 tax audit by the NTS, (iii) the discovery that Lone Star had been defrauded by one of its own Korea-based executives, and (iv) the growing influence of anti-foreign civic groups and left-wing media outlets.

1. Bank Sales by Newbridge and Carlyle Provoke Anti-Foreign Sentiment

141. By 2005, the Korean economy had recovered, and share prices across the banking sector were on the rise. In this new setting, the foreign private equity funds once viewed as rescuers of Korean banks were recast as opportunists, *i.e.*, investors who sought to take

advantage of Korea during a period of financial vulnerability and then exit the country with a substantial profit. Spec Watch coined the word “meoktwi” or “eat and run” to capture this notion.²³⁶ Early examples that were labeled as “eat and run” speculative capital included Carlyle, which sold its stake in KorAm Bank to Citibank in March 2004,²³⁷ and Newbridge, which sold its stake in KFB to Standard Chartered in April 2005.²³⁸ Both funds realized considerable profits from the sales and were able to exit Korea without paying taxes on their capital gains because they were organized under the laws of Labuan, Malaysia, a well-known tax haven.²³⁹ The Korean public was angered by this pattern of behavior. As Mr. Wacker observes, “Many Koreans had misgivings about the tax structure of these transactions, which, even though common and perfectly legal, were viewed as the equivalent of tax evasion.” As it happened, the public’s anger peaked around the time LSF-KEB tried to sell its stake in KEB.²⁴⁰

142. Although commonly grouped with Carlyle and Newbridge under the label of “eat and run” investors, LSF-KEB was especially singled out as speculative capital, and the hostility it faced was on a different order of magnitude from anything encountered by Newbridge or Carlyle.²⁴¹ LSF-KEB’s less favorable treatment stemmed primarily from the fact that LSF-KEB’s acquisition of KEB was the last and the largest of the claimed “eat and run” transactions. By the time the anti-speculative capital campaign ramped up at the end of 2005, Carlyle and

²³⁶ “Preventing Tax Evasion By Foreign Investment Firms,” *Hankyoreh*, April 15, 2005 [Exhibit C-099].

²³⁷ “Approval for Acquisition of Shares in KorAm Bank Co., Ltd. by Citigroup, Inc.,” FSC Press Release, March 26, 2004 [Exhibit C-064].

²³⁸ “Approval for Acquisition of Shares in Korea First Bank by Standard Chartered Bank,” FSC Press Release, April 8, 2005 [Exhibit C-075].

²³⁹ See Thomson Witness Statement at para. 24 [Exhibit CWE-007].

²⁴⁰ Ramstad Witness Statement at para. 5 [Exhibit CWE-005].

²⁴¹ “Foreign Capital Eats Away Domestic Financial Market,” *Hankyoreh*, November 26, 2003 [Exhibit C-059].

Newbridge had already made their exits, leaving Lone Star to bear the brunt of the public outcry.²⁴²

2. High-Profile Tax Raids Inflame Public Sentiment

143. Between Carlyle's sale of its stake in KorAm Bank and Newbridge's sale of KFB, Claimant Star Holdings SCA ("Star Holdings") sold STC, the company that owned Star Tower, a landmark office building in southern Seoul.²⁴³ The press was rife with articles expressing outrage about Lone Star's profits on the sale.²⁴⁴ Moreover, like Carlyle and Newbridge, no Korean tax was due on the gain Star Holdings realized on the sale, due to the applicability of the Korea-Belgium Tax Treaty (this is discussed in detail later). Thus, like the Carlyle and Newbridge transactions, the STC sale played into the hands of civic groups and left-wing media outlets that had painted foreign private equity funds as opportunists out to strip Korea of its wealth, and "flee" without paying tax.²⁴⁵

144. These prominent and lucrative sales attracted the attention of Korean tax authorities. In response to the public outcry and intense political pressure,²⁴⁶ the NTS brought

²⁴² "Foreign Capital Eats Away Domestic Financial Market," *Hankyoreh*, November 26, 2003 [Exhibit C-059]; "Dinosaur Banks Are Heading Backwards," *Hankyoreh 21*, December 3, 2004 [Exhibit C-320].

²⁴³ See Tax Assessment Notice to Lone Star Fund III (U.S.) L.P. Concerning the Star Tower Sale, December 2005 [Exhibit C-355].

²⁴⁴ "Still No Measures for Reverse Discrimination," *Maeil Business Newspaper*, January 16, 2005 [Exhibit C-073]; "Why Korea Does Not Levy a Tax on Capital Gains of Speculative Firms While Japan Does?," *Pressian*, January 18, 2005 [Exhibit C-074]; "The Blue House Began Reviewing Measures for Dealing with Speculative Capitals Early This Year," *Donga Ilbo*, April 15, 2005 [Exhibit C-078]. "Crack Down The Slick Funds," *Hankyoreh 21*, April 26, 2005 (urging the imposition of tax on the foreign PEFs) [Exhibit C-088].

²⁴⁵ "Still No Measures for Reverse Discriminations," *Maeil Business Newspaper*, January 16, 2005 [Exhibit C-073]; "Crack Down the Slick Funds," *Hankyoreh 21*, April 26, 2005 (urging the imposition of tax on the foreign PEFs) [Exhibit C-088].

²⁴⁶ See "S. Korean Tax Authorities to Wrap Up Probes of Foreign Funds Next Month," *Yonhap News Agency*, June 16, 2005 (noting that the "NTS launched its tax inquiry into some foreign funds in April this year amid growing criticism in South Korea about overseas funds reaping hefty profits from investments in the country") [Exhibit C-090]; "The Blue House Began Reviewing Measures for Dealing with Speculative Capitals Early This Year," *Donga*

the full investigative and coercive power of the State's taxation arm to bear on Lone Star and several other private equity funds operating in Korea.²⁴⁷ Indeed, the NTS was surprisingly transparent about the fact that public pressure was behind its decision to audit foreign private equity funds like Lone Star. In an interview with The Korea Herald, an NTS official explained:

More than anything, the current situation is that the *Korean public is casting suspicion on the foreign funds*, which through such activities as noted above, collected large profits and did not pay a penny in taxes by using tax haven.²⁴⁸

145. The NTS initiated its campaign against Lone Star in April 2005 with a series of unlawful raids on the Seoul offices of Lone Star-affiliated service companies, LSAK and HAK.²⁴⁹ The NTS conducted these raids in open disregard of Korean law. Like most modern legal systems, Korean law requires law enforcement agencies like the NTS to obtain either a judicially issued warrant or the property owner's consent before entering and searching the private property.²⁵⁰ The NTS had neither.²⁵¹

146. Nevertheless, on April 12, 2005, between forty and fifty NTS agents illegally attempted to raid the Seoul offices of LSAK and HAK. Lone Star employees resisted these

Idbo, April 15, 2005 ("There is also the view that the direct cause of the tax audit was soured 'public sentiment.'") [Exhibit C-078].

²⁴⁷ See Grayken Witness Statement at para. 21 [CWE-002]; "Seoul Tax Inquiry on Foreign Funds," *New York Times*, April 15, 2005 [Exhibit C-080].

²⁴⁸ "NTS Explains on Its Homepage the Reasons, Timing of 'Tax Audit into Foreign Funds,'" *Money Today*, April 22, 2005 (emphasis added) [Exhibit C-083].

²⁴⁹ See "Seoul Tax Inquiry on Foreign Funds," *The New York Times*, April 15, 2005 [Exhibit C-080]; "Foreign Funds' Frowns," *Korea Times*, April 25, 2005 (describing the repeated visits and "blitzkrieg style" of the tax probes) [Exhibit C-087].

²⁵⁰ See Expert Opinion of Chang Hee Lee, October 8, 2013 ("Lee Expert Opinion") at para. 17 [Exhibit CWE-012].

²⁵¹ See Thomson Witness Statement at para. 25-27 [Exhibit CWE-007]; Grayken Witness Statement at para. 21 [Exhibit CWE-002].

illegal incursions.²⁵² Over the coming days, the NTS made repeated attempts to forcibly enter the offices of both LSAK and HAK, without permission or a search warrant.

147. Michael Thomson, General Counsel of Lone Star, was not in Korea at this time, but he was briefed daily on developments by the President and chief financial officer of HAK on the developing situation. He was told that the NTS had made repeated attempts to forcibly enter the LSAK and HAK offices, including at least one attempt to physically storm the door.²⁵³ After several days of this standoff, HAK and the NTS reached a temporary resolution. NTS auditors would be given access to electronic and paper files that were responsive to the matters under audit, while other files (*i.e.*, confidential or proprietary records that had no relevance to the audit) would be segregated in a secure area of the office.²⁵⁴ Having been told that the NTS would wait to decide how to handle the segregated files until he arrived in Seoul, Mr. Thomson boarded a plane to Seoul.²⁵⁵

148. Mr. Thomson arrived on April 25, 2005, and promptly arranged for an in-person meeting with NTS officials to negotiate a consensual disclosure of records to facilitate the NTS's audit.²⁵⁶ Mr. Thomson met with NTS officials and explained that Lone Star's main concern was to protect from potential disclosure certain proprietary, privileged, and highly confidential documents that were in any case outside the scope of the NTS's tax audit. He made it clear that

²⁵² See "Lone Star Investigation – History of the Ordeals of the International Transaction Investigation Bureau (formerly, International Transaction Management Bureau) within the Seoul Regional Tax Office," *Taxation Daily*, August 19, 2005 ("On April 12, after 48 hours of long drawn clash with Lone Star, the Bureau succeeded in securing the company's accounting materials.") [Exhibit C-092]; see Thomson Witness Statement at paras. 25-27 [Exhibit CWE-007].

²⁵³ Thomson Witness Statement at para. 25 [Exhibit CWE-007].

²⁵⁴ Thomson Witness Statement at para. 26 [Exhibit CWE-007].

²⁵⁵ Thomson Witness Statement at para. 26 [Exhibit CWE-007].

²⁵⁶ Thomson Witness Statement at para. 27 [Exhibit CWE-007].

he was not giving the NTS permission to access those documents, and he fully expected that they would not seize the documents unless they obtained a warrant for the search.

149. None of this was of any use. As Mr. Thomson explains, “The NTS official immediately picked up his phone and promptly instructed his staff to break into those offices and confiscate the segregated files.”²⁵⁷ With this order, the NTS agents on site called a locksmith to pick the lock on the LSAK/HAK’s office door. The NTS, lacking both consent and or a warrant, entered the LSAK and HAK offices and proceeded to indiscriminately seize files that categorically had no bearing on any conceivable issue of Lone Star’s taxes.²⁵⁸

150. Naturally, the actions of the tax authorities only reinforced public suspicions that Lone Star was evading taxes, which generated further hostility in the media.²⁵⁹ They also gave Lone Star a glimpse of just how far the Korean government would go to appease public sentiment. As Mr. Grayken recalls, the tax raids “provided us with some indication of the extent of the power wielded by the Korean government over the market and over foreign investors.”²⁶⁰

3. Steven Lee’s Embezzlement from Lone Star

151. One unexpected finding from the NTS audit was the discovery that Lone Star had been the victim of embezzlement by Mr. Steven Lee, the head of Lone Star’s Korea-based operations.²⁶¹ Mr. Lee had left Korea when the tax audit began in April 2005.²⁶² He told friends

²⁵⁷ Thomson Witness Statement at para. 27 [Exhibit CWE-007].

²⁵⁸ Thomson Witness Statement at para. 27 [Exhibit CWE-007].

²⁵⁹ “Invisible Hands That Helped Lone Star Stream 3 Trillion Won,” *Ohmynews*, February 16, 2006 [Exhibit C-106]; “Lone Star Did Not Pay Tax After Enormous Profit,” *Maeil Business Newspaper*, April 14, 2005 [Exhibit C-077].

²⁶⁰ Grayken Witness Statement at para. 18 [Exhibit CWE-002]; “National Tax Service, ‘We Are Confident in Taxing Foreign Funds,’” *Tax Daily Newspaper*, May 10, 2005 [Exhibit C-089]. “Lone Star’s Apology and Payment of Tax,” *Herald Economy Newspaper*, December 16, 2005 (This article states that Lone Star’s payment of tax imposed regarding the sale of Star Tower is a victory for reestablishing Korea’s Tax Sovereignty) [Exhibit C-102].

²⁶¹ Short Witness Statement at para. 21 [Exhibit CWE-006].

and colleagues that he needed time to move his family back to the United States and later that he was contemplating retirement. According to Mr. Thomson:

It was only in summer 2005 when Lone Star conducted its own investigation of its South Korea operations, that it first identified suspicious transactions with fictitious vendors that Mr. Lee had authorized, as well as transactions directed to accounts in the name of Mr. Lee or related parties.²⁶³

152. When recognizing the seriousness of this misconduct, Lone Star conducted a thorough and prompt review of the falsified paperwork that Mr. Lee had used to obscure his embezzlement of company funds.²⁶⁴ Lone Star determined that Mr. Lee's fraud had caused various Lone Star affiliates in Korea to unwittingly claim unjustified tax deductions.²⁶⁵ Thus, Lone Star proactively approached the NTS to disclose Mr. Lee's malfeasance, with a view toward working cooperatively with the NTS to reconcile any improper tax positions and pay any resulting tax deficiencies.²⁶⁶

153. Rather than commend Lone Star on its diligence and proactive remedial efforts, the NTS resorted essentially to blackmail. In a late September 2005 meeting, the NTS told Mr. Thomson that it could "keep quiet" regarding Mr. Lee's embezzlement *if* Lone Star acquiesced to the NTS's unlawful \$100 million tax assessment on the STC sale.²⁶⁷ The alternative, according to the NTS, was that it would report the embezzlement to other financial regulators,

²⁶² At the time, Mr. Steven Lee told Lone Star's management that he was returning to the United States for family and personal reasons. Thomson Witness Statement at para. 31 [Exhibit CWE-007].

²⁶³ Thomson Witness Statement at para. 31 [Exhibit CWE-007].

²⁶⁴ Thomson Witness Statement at para. 31 [Exhibit CWE-007].

²⁶⁵ Thomson Witness Statement at para. 32 [Exhibit CWE-007].

²⁶⁶ Thomson Witness Statement at para. 32 [Exhibit CWE-007].

²⁶⁷ Thomson Witness Statement at para. 32 [Exhibit CWE-007].

like the FSS, potentially resulting in a variety of regulatory problems.²⁶⁸ Mr. Thomson refused this improper request.

154. In keeping with this threat, on October 6, 2005, the NTS formally notified the FSS of potential wrongdoing by Lone Star and Mr. Lee.²⁶⁹ The NTS's allegations involved purported tax evasion, as well as an alleged violation of the Asset-Backed Securities Law and the Foreign Exchange Transaction Law. Around the same time, the NTS filed a criminal complaint with the Supreme Prosecutor's Office ("SPO"). In effect, the NTS took the view that Mr. Lee's financial wrongdoing, which involved stealing money from Lone Star, could be used to indict Lone Star's general business practices.²⁷⁰ Thus, the NTS irrationally sought to attribute the wrongdoing of the victimizer to the victim.

155. Mr. Lee's embezzlement was yet another factor contributing to the perception that Lone Star was operating in disregard of Korean law. Even though Lone Star was the victim of Mr. Lee's fraud and had been forthcoming in reporting it to the Korean government, Korean prosecutors and tax authorities seized on the opportunity to ratchet up scrutiny of Lone Star.

4. Spec Watch, Activist Groups, and the Media See an Opportunity to Create a Scandal

a. Spec Watch Korea Launches a Public Campaign, as Its Leader Threatens to "Get Even" with Lone Star

156. As explained, Spec Watch was established in the wake of the KEB Card merger in August 2004 by Mr. Hwa-sik Jang, the former leader of KEB Card's labor union (infamous

²⁶⁸ Thomson Witness Statement at para. 32 [Exhibit CWE-007]; see also "Confidence in Lone Star Nosedives....Likely to Negatively Impact Investment Activities," *Money Today*, October 6, 2005 [Exhibit C-095].

²⁶⁹ See "NTS Files 2 Complaints of Tax Evasion . . . the First For a Foreign Fund," *Money Today*, October 6, 2005 [Exhibit C-096].

²⁷⁰ Thomson Witness Statement at para. 33 [Exhibit CWE-007].

for the “knife incident” involving KEB Card’s former acting CEO), who had sworn to “get even” with Lone Star.²⁷¹ As Mr. Wacker explains,

Spec Watch aligned with other civic groups and politicians who were critical of the market economy reforms that had been implemented in the aftermath of the Asian financial crisis. They tapped into a wave of public sentiment against foreign business interests coming into Korea, particularly those who were perceived to have taken advantage of Korea’s weakness during the crisis.²⁷²

157. Shortly after it was established, Spec Watch began lobbying the Korean government to investigate a wide assortment of allegations of misconduct surrounding the KEB acquisition and the subsequent merger between KEB and KEB Card.²⁷³ For the most part, the allegations against Lone Star fell into two categories: Lone Star was accused of (i) conspiring with regulators and KEB officials to exaggerate the severity of KEB’s financial condition in order to gain exemption from shareholding limitations and acquire KEB at a below-market price and (ii) conspiring with KEB to bring the KEB Card’s share price down so that KEB could merge with the credit card subsidiary at a favorable price.

158. With the help of allies in the National Assembly, Spec Watch obtained documents relating to the 2003 KEB acquisition and began building its own case against Lone Star.²⁷⁴ In September 2004, Spec Watch filed a criminal complaint with the SPO naming 20 individuals

²⁷¹ “Establishment of Spec Watch,” Spec Watch Press Release, August 27, 2004 [Exhibit C-066].

²⁷² Wacker Witness Statement at para. 32 [Exhibit CWE-008].

²⁷³ “Debate Forum on Foreign Capital Inflow to be Held on the 27th,” *Financial News*, October 22, 2004 [Exhibit C-070]; “Current Economic Authorities Are Like a Weak Soccer Team with 11 Strikers,” *OhmyNews*, October 27, 2004 (articles reporting the joint panel discussion on the topic of “Issues on How to Handle the Entry of Foreign Capital in Korea,” hosted by the Financial Economy Institute, with participation from National Assemblywoman Shim Sang-jung (DLP) and Spec Watch, and other civic organizations) [Exhibit C-072].

²⁷⁴ “Special Edition: Lone Star Fund, Korean Investors Must Be Revealed,” *Hankyoreh 21*, June 29, 2006 [Exhibit C-136].

involved in alleged wrongdoing.²⁷⁵ The following month Spec Watch filed a lawsuit against the FSC seeking to nullify the agency's approval of Lone Star's 2003 KEB acquisition.²⁷⁶ In addition to its litigation and media campaigns, Spec Watch worked closely with opposition parties and members of the National Assembly to draw attention to their cause. Toward this end, Spec Watch made appearances before the National Assembly²⁷⁷ and hosted policy forums with politicians and other civic groups.²⁷⁸ Spec Watch remained a vocal critic of Lone Star throughout the period of LSF-KEB's investment.²⁷⁹

159. Spec Watch was joined in its opposition to Lone Star by several other civic groups, including Solidarity for Economic Reform ("Solidarity"), a watchdog group established in the wake of the financial crisis,²⁸⁰ and People's Action, which was short for "People's Action for the Investigation on Suspicion of Lone Star-gate and Suspension of the Resale of KEB Shares," a group consisting of labor unions, National Assembly politicians, and members of Spec

²⁷⁵ "Criminal Complaints Brought against 20 Persons Involved in the KEB Sale," *Money Today*, September 14, 2005 [Exhibit C-067]. Spec Watch also initiated a campaign to 1 million signatures in support of a petition urging the National Assembly to hold a public hearing on the Lone Star deal. See "Speculative Watch Center Starts a Signature Campaign to Hold a Public Hearing on Sale of KEB," *The Korea Economic Daily TV*, October 26, 2005 [Exhibit C-100].

²⁷⁶ "Initiating the Lawsuit for the Nullification of the Approval for Acquisition of KEB Shares By Lone Star Fund," Spec Watch Korea Press Release, October 14, 2004 [Exhibit C-068].

²⁷⁷ Minutes of National Assembly Finance and Economy Committee, Inspection on Ministry of Finance and Economy, October 4, 2005, at 90 [Exhibit C-093]; National Assembly Minutes, October 10, 2005 [Exhibit C-097].

²⁷⁸ "Debate Forum on Foreign Capital Inflow to be Held on the 27th," *Financial News*, October 22, 2004 [Exhibit C-070]; "Stop the Sale of KEB," *Sisa Journal*, April 17, 2006 (News article on joint candlelight demonstrations with participation from Spec Watch, People's Action, and Financial Labor Organization) [Exhibit C-121].

²⁷⁹ "Spec Watch Says, 'Sale of KEB Is a Lone Star Scandal,'" *Yonhap Infomax*, March 20, 2006 [Exhibit C-322]; "Foreign Press Conference: KEB-Lone Star Gate," Spec Watch Press Release, February 11, 2008 [Exhibit C-178].

²⁸⁰ "Inquiries on Whether LSF-KEB Holdings, SCA, A Majority Shareholder of KEB, Qualifies For a Non-Financial Business Operator," Press Release by Solidarity for Economic Reform and the People's Solidarity for Participatory Democracy, March 27, 2007 [Exhibit C-153].

Watch itself.²⁸¹ Taking cues from Spec Watch, these groups lobbied the government to launch legal probes into allegations of wrongdoing surrounding the original acquisition and block any potential sale of LSF-KEB's stake in KEB.²⁸²

b. The Media Rails Against "Foreign Speculative Capital," Further Provoking Anti-Lone Star Sentiment

160. The anti-foreign civic groups had a strong ally in the Korean media. Left-wing media outlets began drawing attention to "foreign speculative capital" as early as 2003.²⁸³ Expressing views that would come to define public sentiment, editorialists accused "slick"²⁸⁴ foreign funds of "eat[ing] away" Korean assets.²⁸⁵ They singled out the KEB acquisition as a "crime" aided by the Korean government and demanded that all Korean investors in Lone Star's funds be revealed.²⁸⁶ Centrist and conservative outlets soon jumped on the bandwagon.

161. Lone Star was a daily headline story in the news media. On any given day, coverage of the Lone Star saga appeared in multiple media outlets. In March 2006, when Assemblywoman Kyung-won Na announced that the Blue House (the office of the Korean President) may have been involved in alleged wrongdoing surrounding the KEB acquisition, no

²⁸¹ "Establishment of People's Action for Stopping the Illegal Sale of KEB . . . and Recovering the Truth Surrounding the Lone Star Gate," *Pressian*, April 4, 2006 [Exhibit C-114]; "Civic Organization Asks for Truth Surrounding the Illegal Sale of KEB," *Kyunghyang Newspaper*, May 22, 2006 [Exhibit C-185].

²⁸² Shortly after it was established in May 2006, People's Action delivered to the Blue House a petition calling for the suspension of LSF-KEB's agreement to sell KEB to Kookmin. "Civic Organization Asks for Truth Surrounding the Illegal Sale of KEB," *Kyunghyang Newspaper*, May 22, 2006 [Exhibit C-185]. In 2007, Solidarity sent questionnaires to the FSS and the KEB Board concerning Lone Star's qualification as a majority shareholder. See "Inquiries on Whether LSF-KEB Holdings, SCA, A Majority Shareholder of KEB, Qualifies For a Non-Financial Business Operator," Press Release by Solidarity for Economic Reform and the People's Solidarity for Participatory Democracy, March 27, 2007 [Exhibit C-153].

²⁸³ "Selling Away Banks Must Stop," *Hankyoreh 21*, December 25, 2003 [Exhibit C-061]; "Foreign Capital Eats Away Domestic Financial Market," *Hankyoreh 21*, November 26, 2003 [Exhibit C-059].

²⁸⁴ "Crack Down The Slick Funds," *Hankyoreh 21*, April 26, 2005 [Exhibit C-088].

²⁸⁵ "Foreign Capital Eats Away Domestic Financial Market," *Hankyoreh 21*, November 26, 2003 [Exhibit C-059].

²⁸⁶ "Special Edition: Lone Star Fund, Korean Investors Must Be Revealed," *Hankyoreh 21*, June 29, 2006 [Exhibit C-136].

fewer than 10 news outlets covered the story.²⁸⁷ Throughout 2006, *Hankyoreh*21, a leading left-wing magazine, devoted a special section of its weekly publication to developments in the Lone Star case.²⁸⁸

162. On March 19, 2006, the Korea Broadcasting System (“KBS”) aired a widely viewed so-called exposé on the KEB acquisition. The segment, which promised an “in depth report on secrets behind [the] sale of KEB,” echoed many of the charges being leveled by the civic groups, including an allegation that Lone Star conspired with government officials to make KEB’s financial position appear to be more dire than it actually was and thereby reduce the price to LSF-KEB.²⁸⁹ The KBS broadcast signaled that the anti-Lone Star camp had successfully moved the issue out of the fringe media and specialized financial press and into the living rooms of the general Korean public.²⁹⁰

5. Labor Unions Join the Attacks on Lone Star

163. LSF-KEB also faced hostility from organized labor, a powerful force in Korean politics. The hostility came from two fronts: (i) the former KEB Card union (and later Spec Watch, the organization in which it was re-embodied); and (ii) the KEB union. As noted, hostility from the KEB Card union and Spec Watch was constant and unrelenting, and it was

²⁸⁷ “The Blue House Intervened in the Sale of KEB,” *YTN News*, March 9, 2006 [Exhibit C-109]. See Articles Discussing Kyung-won Na's Allegations Regarding Blue House and KEB, Naver News, March 9, 2006 [Exhibit C-193].

²⁸⁸ See, e.g., “Non-existing management Skill Is Created Just Within a Year? Comparison of Sale Process between Seoul Bank and Korea Exchange Bank,” *Hankyoreh*, April 17, 2006 [Exhibit C-422]; “Special Edition: Lone Star Fund Korean Investors Must be Revealed,” *Hankyoreh* 21, June 29, 2006 [Exhibit C-136].

²⁸⁹ Transcription of a Documentary on the Illegal Purchase of KEB by Lone Star,” KBS Special Documentary, March 31, 2006 [Exhibit C-110].

²⁹⁰ “Over Half of Koreans Say, ‘Sale of KEB Is a Lone Star Scandal,’” *WOW TV*, May 2, 2006 (Quoting the poll led by KEB’s Labor Union) [Exhibit C-127].

these groups that brought the Lone Star controversy to the attention of the National Assembly and various investigative agencies.²⁹¹

164. Hostility from the KEB union came more in fits and starts. Nevertheless, when it did flare up, it proved highly disruptive to day-to-day operations at KEB.²⁹² For example, in demonstrating against KEB's July 2011 dividend payment, KEB union members stopped at nothing to get their point across, and at one point barred KEB's management from the bank's headquarters for the better part of a month.²⁹³

F. PARTISAN POLITICS AND POLITICAL OPPORTUNISM LEAD THE NATIONAL ASSEMBLY AND GOVERNMENT AGENCIES TO TARGET LONE STAR

165. By the fall of 2005, the controversy over Lone Star evolved from public outrage to political battleground. Anything to do with Lone Star and KEB was a political scandal in the making. With the help of an antagonistic media, civic groups like Spec Watch had spent months whipping up hostility toward Lone Star and the financial regulators who approved the KEB acquisition. Flimsy allegations of conspiracy and corruption had captured the public imagination, and there was growing acceptance of the view that Lone Star's investment in KEB "must have been" the product of illegal conduct.²⁹⁴ With daily media headlines, Lone Star was a sensational target for political opportunists, and politicians in and outside the National Assembly were quick to get involved.

²⁹¹ See Statement of Facts, Sec. III.E. 4.

²⁹² "More Than 1 Million Citizens Signed Up For the Nation-Wide Campaign to Nullify the Illegal Sale of KEB to Lone Star!," FSS Bulletin Board, August 28, 2006 (discussing KEB labor union's campaign for an order to for LSF-KEB to sell the KEB shares at the acquisition price) [Exhibit C-140].

²⁹³ Klane Witness Statement at paras. 20-21 [Exhibit CWE-003].

²⁹⁴ Klane Witness Statement at para. 20 [Exhibit CWE-003].

166. With public opinion turning against Lone Star, opponents of President Roh Moo-hyun seized on the controversy as an opportunity to punish the ruling party for its ties to “eat and run” capital by linking it to allegations of wrongdoing surrounding Lone Star’s initial acquisition of KEB. The involvement of these opposition politicians, together with the flurry of investigations they launched, only further emboldened the anti-foreign civic groups, creating a feedback loop that would make Lone Star one of the defining political issues of the 2006-2007 election cycle.

167. In this setting, regulators had every incentive to avoid taking action on the KEB acquisition. The anti-Lone Star camp never missed an opportunity to target a public official perceived as taking action in favor of Lone Star. Indeed, as discussed below, Dr. Yang-ho Byeon, an esteemed financial regulator and the former MOFE official who helped facilitate the 2003 sale of KEB, was jailed and ultimately prosecuted for his involvement in the transaction. Unwilling to risk professional ruin (much less jail time) by getting caught up in the controversy, regulators simply chose not to act. Such bureaucratic paralysis became commonly known as “Byeon Yang-ho syndrome.”²⁹⁵ Avoiding blame, as Richard Wacker observes, was a matter of “professional self-preservation.”²⁹⁶

1. The “Lone Star Sniper” and Other Political Opportunists in the National Assembly Attack Lone Star

168. Korea has undergone several major political shifts since its transition to democracy in 1987. After conservatives controlled the Blue House for the first decade of the democratic era (1987–1998), the 1998 election ushered in a new era of Korean politics and ten

²⁹⁵ “‘Byeon Yangho Syndrome’ of the Financial Bureaucrats,” *Donga Daily Newspaper*, November 16, 2011 [Exhibit C-273].

²⁹⁶ Wacker Witness Statement at para. 43 [Exhibit CWE-008].

years of progressive rule, beginning with President Kim Dae-jung (1998–2003) and followed by President Roh Moo-hyun (2003–2008). It was toward the middle and end of President Roh’s term, with opposition parties gearing up to reclaim power, that the Lone Star controversy became a political battleground.

169. Lone Star was fully thrust into partisan politics in late 2005. By this point, the NTS’s high-profile audit into foreign investment funds had been drawing daily press coverage, and Lone Star was beginning to experience fallout from news of Steven Lee’s embezzlement, which, as Mr. Thomson points out, “became known publicly at about the same time as LSF-KEB reached the end of the two-year lock-up period preventing it from selling its stake in KEB.”²⁹⁷ With the convergence of these developments, much of the media scrutiny and animosity was focused on Lone Star.

170. The political escalation occurred in three stages. It began with individual politicians who seized the opportunity to use the Lone Star controversy for their own political gain. These politicians developed their political reputations specifically as anti-Lone Star crusaders bent on punishing Lone Star and the government officials who had facilitated its investment in Korea. In the second stage, as the magnitude of the controversy came into sharper focus, opposition political parties joined the fray, using the public outcry over Lone Star and KEB to inflict damage on the Roh Administration. The political parties insisted that the wrongdoing surrounding Lone Star’s 2003 acquisition of KEB reached the highest levels of government, and in particular the MOFE, which played a key role in brokering the transaction between Lone Star and KEB. In the final stage, the National Assembly (as distinct from the

²⁹⁷ Thomson Witness Statement at para. 35 [Exhibit CWE-007]; “Confidence in Lone Star Nosedives....Likely to Negatively Impact Investment Activities,” *Money Today*, October 6, 2005 [Exhibit C-095].

political parties which populate it) began taking official steps to investigate the KEB acquisition. The involvement of the National Assembly signaled a major escalation in the Lone Star saga, which in the eyes of the Korean press had graduated from a controversy over a bank sale into a full-blown political scandal—“Lone Star-gate.”

a. Politicians Use the Lone Star Controversy to Raise Their Political Profile

171. National Assemblywoman Kyung-won Na, a member of the opposition Grand National Party (“GNP”), was a political novice when she first began publicly questioning the legality of LSF-KEB’s acquisition of KEB.²⁹⁸ Soon hailed as the “Lone Star sniper,” her prominence in pressing the Lone Star issue helped her climb the ranks of the GNP, first as GNP spokesperson and later as a key aide to GNP presidential candidate Lee Myung-bak, who went on to win the presidency in 2008.

172. Elected in May 2004, Assemblywoman Na began raising questions about Lone Star’s KEB acquisition almost immediately after she took office. For example, in October 2004, during the State Affairs Committee’s Inspection of the FSS and FSC, she accused financial regulators of using a double standard in favor of foreign investors in approving the KEB acquisition, questioning the government’s determination that the bank was in distress at the time of the acquisition.²⁹⁹ At the same hearing, she joined a group of politicians in accusing financial regulators of resorting to expediency.³⁰⁰ She also proposed a National Assembly resolution calling for a Board of Audit (“BAI”) inspection into the KEB acquisition, which led to the GNP

²⁹⁸ “I’m the Lone Star Sniper – Lawmaker Na Kyung-won has Been Trying to Prevent the Outflow of National Wealth for Three Years,” *Seoul Economics Daily News*, June 23, 2006 [Exhibit C-135].

²⁹⁹ Minutes of the State Affairs Committee’s Inspection on the FSC and FSS, October 21, 2004 (“State Affairs Committee’s Minutes, October 21, 2004”) [Exhibit C-069].

³⁰⁰ State Affairs Committee’s Minutes, October 21, 2004 [Exhibit C-069].

making Lone Star one of the defining issues of its campaign during the May 2006 local elections.³⁰¹

173. In July 2011, Na was elected to the GNP's Supreme National Council and won the GNP's bid to run for mayor of Seoul, the same post President Lee had held before he sought the presidency in 2008. During the mayoral race (which Na ultimately lost), one of her preferred slogans was "Lone Star Sniper Kyung-won Na / Lone Star Beneficiary [name of opponent]."³⁰²

174. Mr. Kyung-hwan Choi, also of the GNP, is another public official who owes his political success to the Lone Star saga. As with Na, Assemblyman Choi began focusing on Lone Star shortly after he was elected in May 2004. He first gained attention in October 2004 when, echoing a catchphrase commonly used by Spec Watch and other anti-foreign fringe groups, he referred to the 2003 KEB acquisition as a "fire sale," suggesting that the transaction had been manipulated to give off the impression that Lone Star paid a higher price than it did.³⁰³ As it turned out, Choi had been collaborating with Mr. Hwa-sik Jang of Spec Watch to produce "Revelation of the Conspiracy and the Facts Behind Lone Star's Acquisition of KEB," a widely published report that gained Choi national visibility as one of the leaders of the National Assembly's opposition to Lone Star.³⁰⁴ In 2007 Choi became a member of President-elect Lee Myung-bak's transition team and later served as Minister of the Ministry of Knowledge and

³⁰¹ "Na Kyung-won Submits Proposal for Inspection by the Board of Audit and Inspection," *Yonhap News*, December 6, 2005 [Exhibit C-101]. This proposal was accepted by the National Assembly on February 16, 2006. See Minutes of the State Affairs Committee's Inspection on the FSC and FSS [Exhibit C-105].

³⁰² "While Kyung-won Na Exposed Lone Star Won-soon Park Took Money," *New Daily*, November 8, 2011 [Exhibit C-413]; "I'm the Lone Star Sniper – Lawmaker Na Kyung-won has Been Trying to Prevent the Outflow of National Wealth for Three Years," *Seoul Economics Daily News*, June 23, 2006 [Exhibit C-135].

³⁰³ See Minutes of National Assembly Finance and Economy Committee, Inspection on KEXIM Bank, October 18, 2004 [Exhibit C-029].

³⁰⁴ National Assemblyman Kyung-hwan Choi, Report on Revelation of the Conspiracy and the Facts Behind Lone Star's Acquisition of KEB", October 10, 2005 [Exhibit C-098]; Minutes of National Assembly Finance and Economy Committee, October 10, 2005 [Exhibit C-031].

Economy.³⁰⁵ Choi's political ascendance continued after President Lee left office. Choi played an instrumental role in current President Park Geun-hye's presidential campaign and currently serves as GNP Floor Leader for the National Assembly.³⁰⁶

b. Opposition Parties Use Lone Star to Attack the Roh Administration

175. The October 2005 release of Choi's report coincided with the National Assembly's 2005 National Audit. The National Audit is the National Assembly's annual inspection of executive branch expenditures. The audit places the National Assembly in opposition to the ruling Administration, and it is natural (and quite common) for opposition parties to lead the charge. The 2005 National Audit was no exception. In October 2005, in connection with the release of his report purporting to reveal a "conspiracy" behind the KEB acquisition, Assemblyman Choi called on regulators to put LSF-KEB's plans to sell its KEB shares on hold.³⁰⁷ Insisting that Lone Star would try to exit Korea upon the expiry of its lock-up period, Choi called for measures to block a potential sale, including a preliminary court injunction as well as "stronger measures" such as the appointment of a special prosecutor.³⁰⁸ This prompted members of the Finance & Economy Committee of the National Assembly to announce an independent review of the evidence—the first in a series of investigations that would move the Lone Star controversy to the center of national politics.³⁰⁹

³⁰⁵ "Profiles of New Ministers," *Korea Herald*, September 4, 2009 [Exhibit C-363].

³⁰⁶ "President's Confidant Elected as Floor Leader," *Korea Times*, May 21, 2009 [Exhibit C-427].

³⁰⁷ National Assemblyman Kyung-hwan Choi, "Report on Revelation of the Conspiracy and the Facts Behind Lone Star's Acquisition of KEB," October 10, 2005 [Exhibit C-098].

³⁰⁸ Minutes of National Assembly Finance and Economy Committee's Inspection on National Economy Advisory Council, October 10, 2005 [Exhibit C-097].

³⁰⁹ Minutes of State Affairs Committee, October 11, 2005 [Exhibit C-324]; Minutes of the Finance and Economy Committee, February 21, 2006 (The final report containing the results of the documentary investigation was

176. With the May 2006 local elections approaching, opposition parties became more vocal in their efforts to use the Lone Star issue to attack the Roh Administration by claiming various forms of misconduct by government officials (and Lone Star) in the 2003 transaction and thereafter.³¹⁰ Politicians began referring to the controversy as “Lone Star-gate,” insisting that allegations of wrongdoing could reach the highest levels of government.³¹¹ They sought to convey the fiction that, in a desperate effort to attract foreign investment, the Roh Administration had conspired with Lone Star to manipulate the price of KEB so that Lone Star could acquire the bank at a fire-sale price.³¹² The only question in this revision of history was who inside the Blue House would be implicated in the wrongdoing, and how extensive would the political fallout be when they were. As an official told the Korea Herald in April 2006, “The Lone Star issues have made the public more skeptical toward the government’s policies aimed to accelerate the capital market opening. It’s going to be a hot potato in the coming months as local elections are just around the corner.”³¹³

177. As partisan rhetoric escalated, opposition parties formed internal investigative bodies that worked in concert with civic groups and labor unions to “investigate” the controversy and bring more attention to the issue. The GNP created the “Fact-finding Committee on the

accepted by the National Assembly) [Exhibit C-325]; Final version of National Assembly Finance and Economy Committee’s Report on the Review of Evidence on Lone Star, March 2, 2006 [Exhibit C-326].

³¹⁰ See National Assembly Minutes, February 21, 2006 [Exhibit C-325].

³¹¹ Plenary Meeting of the National Assembly, April 10, 2006 (National Assemblywoman Na announces that the sale of KEB was the collaborative work of President Roh Moo-hyun, who made “a hasty decision to attract foreign investment,” and the MOFE) [Exhibit C-116]; “Lone Star Gate is the Project of the President,” *Jose Daily Newspaper*, April 26, 2006 (Na Kyung-won mentions that the participation of a Blue House member indicated that President Roh Moo-hyun was notified and aware of each and every step of the sale of KEB) [Exhibit C-125].

³¹² “Remarks at National Assembly Briefing, GDP Claims That There Were Opposing Views Within the Government Regarding KEB Sale,” *Yonhap News*, April 12, 2006 [Exhibit C-119].

³¹³ “KEB Sale Dispute Puts Hub Plan in Limbo,” *Korea Herald*, April 13, 2006 [Exhibit C-120].

Illegal Sale of KEB,” while the opposition Democratic Labor Party (“DLP”) created the “Measures Committee for Lone Star-gate.”³¹⁴

178. In the meantime, the anti-Lone Star camp seized on any information it could find to support a link between the Roh Administration and the alleged improprieties relating to the initial sale of KEB shares to Lone Star. On March 9, 2006, Assemblywoman Na said there was evidence that a Blue House official attended a “secret meeting” on the KEB sale.³¹⁵ She would later raise questions about the Blue House’s relationship with former KEB President Kang-won Lee, alleging that Lee used to report to top policymakers at the Blue House.³¹⁶ In this same vein, on May 22, 2006, anti-Lone Star civic group People’s Action called on President Roh to address rumors that former KEB President Kang-won Lee had accompanied him on a trip to China in July 2003, and that a former Blue House official had attended a secret meeting about the KEB transaction.³¹⁷ Likewise, on June 16, 2006, National Assemblywoman Sang-jung Shim claimed that Lone Star’s 2003 investment in KEB implicated high-ranking officials at MOFE, including the Minister himself,³¹⁸ while on June 28, a group of politicians alleged that Hyung-min Kim, a

³¹⁴ “Members of the DLP created ‘Measures Committee for Lone Star-gate,’” *Yonhap News*, March 30, 2006 [Exhibit C-113].

³¹⁵ “Na Gyeong-won Claims the Blue House is Behind the Sale of KEB,” *YTN News*, March 9, 2006 [Exhibit C-109].

³¹⁶ “Na Gyeong-won Claims, the Blue House was Involved in the Sale of KEB,” *Money Today*, October 12, 2006 [Exhibit C-142].

³¹⁷ “Civic Organization Ask for Truth Over the Illegal Sale of KEB,” *Kyunghyang Newspaper*, May 22, 2006 [Exhibit C-185]; “Finance Labor Unions Insist on Halting the Resale of KEB,” *Hankuk Economy*, May 24, 2006, [Exhibit C-327].

³¹⁸ “Lone Star Gate is Actually a Lee Hun-jae, or Mofia Gate,” *CBS Radio*, June 16, 2006 (National Assemblywoman Shim Sang-jung (DLP) indicated that Lone Star-Gate was actually “MOFE-ia Gate,” implying that high ranking government officials at MOFE were involved in the Lone Star case) [Exhibit C-132].

KEB Vice President with close ties to former President Dae-jung Kim, was formerly the Blue House official actually in charge of Lone Star's KEB acquisition.³¹⁹

c. The National Assembly Takes Official Action to Further the Lone Star Investigation

179. In parallel with these individual politicians' efforts, the National Assembly was taking official steps to investigate "Lone Star-gate." On February 21, 2006, the Finance & Economy Committee published the results of its investigation into the KEB purchase,³²⁰ concluding that a criminal investigation would be necessary. In connection with this announcement, several assemblymen alleged that Koreans investors hiding offshore were actually behind the KEB acquisition.³²¹ On February 15, 2006, opposition politicians in the National Assembly submitted a proposal to stop Lone Star's sale of KEB while investigations were pending. The proposal was supported by 147 lawmakers from all four opposition parties.³²² On March 2, 2006, the National Assembly adopted the GNP proposal (driven by Assemblywoman Na) demanding a BAI audit into the events surrounding Lone Star's 2003 acquisition of KEB.³²³ The BAI launched the audit the following day. More significantly, on March 7, 2006, the Finance and Economy Committee filed a criminal complaint with the SPO.

³¹⁹ Minutes of National Assembly Finance & Economy Committee, June 28, 2006. "Witness at This Year's National Assembly Inspection, Who is Kim Hyung-min, the Vice President of KEB?," *Kyunghyang Newspaper*, October 13, 2006 [Exhibit C-143].

³²⁰ Report on Results of Documents Review in connection with KEB acquisition by Lone Star Fund by the Finance & Economy Committee, February 21, 2006 [Exhibit C-098].

³²¹ See National Assembly Minutes, February 21, 2006 [Exhibit C-325].

³²² See National Assembly Resolution Urging Measures to Suspend Disposal of KEB, Proposal No. 3939, February 17, 2006 [Exhibit C-372].

³²³ Minutes of the National Assembly, Plenary Meeting, March 2, 2006 [Exhibit C-108].

180. The criminal complaint was significant in several respects. First, it is exceedingly rare for the National Assembly to resort to the SPO in political scandals like this.³²⁴ Second, with the exception of several cases involving witness perjury, the complaint marked the first time the National Assembly had requested a criminal investigation into a subject the SPO was not already investigating.³²⁵ Stated differently, it was the first time the SPO had launched an investigation into the conduct of the ruling party at the behest of opposition parties in the National Assembly.

181. By summer 2006, “Lone Star-gate” had already taken a toll on the ruling party. President Roh’s approval rating was at an all-time low, having fallen below 15%, and his Uri Party had been dealt a resounding defeat in the May 2006 local elections.³²⁶ In a revealing May 2006 poll, more than three quarters of Koreans surveyed said they believed corruption played a role in Lone Star’s 2003 acquisition of KEB. The Korean public had lost sight of the circumstances surrounding Lone Star’s investment—that Lone Star had emerged as the only investor willing to pour money into KEB, and that Lone Star’s investment helped KEB (and its then-largest shareholder the Korean government) avoid insolvency and likely spared the Korean economy from further turmoil.

182. Rumors of high-level misconduct had gained widespread public acceptance, and opposition parties were hopeful that their allegations against the Roh Administration would be borne out by a string of high-profile SPO indictments. The opposition was therefore

³²⁴With the exception of perjury investigations, the National Assembly seldom initiates criminal complaints against other public officials.

³²⁵ Counsel searched the National Assembly Archives and found no other such cases.

³²⁶ The Uri Party lost 15 of 16 contested races for mayoral and gubernatorial posts, and not a single Uri Party member was elected in any of the 234 races for ward assembly or municipal parliament in Seoul, Incheon, and Kyongki provinces. *See* Panel Survey on Korea’s Local Elections of 2006, Maureen and Mike Mansfield Foundation, 2006 [Exhibit C-103].

disappointed when it received the news that the SPO had indicted only three individuals—Dr. Yang-ho Byeon, the former MOFE official who played a leading role in the 2003 sale of KEB, and former KEB officials Kang-won Lee and Dal-yong Lee—because they had been hoping for the indictment of higher-ranking politicians. In an effort to breathe new life into the criminal investigation, the GNP next requested a Special Independent Prosecutor’s investigation, which was eventually proposed in February 2008.³²⁷

2. LSF-KEB’s Ill-Fated Agreement to Sell KEB to Kookmin

183. While the controversy was swirling, LSF-KEB began considering its options for selling KEB. Under the terms of its Share Subscription Agreement with KEB, LSF-KEB was subject to a two-year “lock-up period” during which it was not allowed to sell its KEB shares.³²⁸ When the lock-up period expired at the end of 2005, LSF-KEB was ready to sell its stake. KEB had recovered, and the bank now had two years of prudent growth and profitability behind it.

184. In January 2006, LSF-KEB decided to solicit bids for its controlling stake in KEB. When the bidding process closed in March 2006, LSF-KEB had offers from three financial institutions (Hana, DBS Bank (“DBS”), and Kookmin).³²⁹ DBS was LSF-KEB’s preferred acquirer.³³⁰ Not only did DBS present the highest bid, but Lone Star had developed a close working relationship with the company’s president, Jack Tai, and felt DBS had the experience

³²⁷ The motion for Special Inspection of Lone Star was put to the National Assembly in 2008 by Assemblyman Im Jongin. See “Motion for Special Inspection of Lone Star was Put to the National Assembly,” *E today News*, February 15, 2008 [Exhibit C-328]. See Draft Act on Appointment of the Special Prosecutor for Investigation Relating to Suspicions about Lone Star’s Acquisition of Korea Exchange Bank, February 15, 2008 [Exhibit C-179].

³²⁸ KEB Shareholders Agreement, October 31, 2003, at Sec. 4.1(a) [Exhibit C-055].

³²⁹ Yoo, *THE INCONVENIENT TRUTH* at 90-91 [Exhibit C-286].

³³⁰ Thomson Witness Statement at para. 39 [Exhibit CWE-007].

and financial strength to continue to grow KEB.³³¹ Furthermore, DBS had promised that it would continue to operate KEB as an independent brand and without laying off workers—two factors that would smooth the way with the KEB labor union.³³²

185. Shortly after the bidding closed in March 2006, an FSC official publicly questioned DBS's eligibility to acquire KEB, citing the company's relationship with its majority shareholder Temasek Holdings ("Temasek"), which had been classified as an industrial conglomerate (or an NFBO).³³³ "From a working perspective, DBS has an issue with its eligibility," said Dae-dong Park, a director general at the FSC.³³⁴ Less formally, financial regulators sent a fax to KEB making clear their opposition to DBS as a potential shareholder.³³⁵

186. This struck everyone involved as an unwarranted and highly unusual way to communicate opposition to a potential acquisition.³³⁶ Since DBS had yet to submit an application, much less the documentation necessary to determine whether its management was independent from Temasek,³³⁷ many observers viewed the FSC's public statements regarding the Temasek issue as a pretext for the actual motivation behind the regulators' opposition, namely, their preference for a Korean buyer for this historic and prestigious bank.³³⁸ In any event, DBS withdrew its proposal.³³⁹

³³¹ Thomson Witness Statement at para. 39 [Exhibit CWE-007].

³³² Thomson Witness Statement at para. 39 [Exhibit CWE-007].

³³³ Yoo, *THE INCONVENIENT TRUTH* at 90-92 [Exhibit C-286].

³³⁴ "DBS has a Problem as Major Shareholder of KEB," *YTN*, March 21, 2006 [Exhibit C-329].

³³⁵ Thomson Witness Statement at para. 41 [Exhibit CWE-007].

³³⁶ Thomson Witness Statement at para. 41 [Exhibit CWE-007].

³³⁷ Thomson Witness Statement at para. 41 [Exhibit CWE-007].

³³⁸ "Doubt Cast on DBS Bid for KEB," *Financial Times*, March 22, 2006 [Exhibit C-112].

³³⁹ Thomson Witness Statement at para. 41 [Exhibit CWE-007].

187. With DBS out of the picture, LSF-KEB turned its attention to Kookmin, the next-highest bidder. On May 19, 2006, LSF-KEB and Kookmin entered into a share purchase agreement (“SPA”) under which Kookmin agreed to purchase LSF-KEB’s 64.6% stake in KEB for approximately KRW 6.3 trillion (approximately \$6.7 billion).³⁴⁰ Under the SPA, either party could terminate the sales contract if the transfer of shares was not completed and closed by September 16, 2006 (120 days from the SPA’s execution).³⁴¹ Moreover, Kookmin conditioned its purchase on the timely conclusion of “any official Proceeding initiated by any Governmental Authority” which presents “a reasonable prospect of materially restraining, enjoining or otherwise preventing the consummation” of the transaction.³⁴²

188. On May 22, 2006, Kookmin applied to the FSC for Excess Shareholding Approval.³⁴³ Several days later, on May 26, 2006, the FSC referred Kookmin’s application to the Fair Trade Commission of Korea (“KFTC”) for review of potential antitrust concerns.³⁴⁴

189. When the September 16, 2006, expiration date passed without any action by the FSC or the KFTC, Kookmin and LSF-KEB discussed extending the SPA by three months.³⁴⁵ But when the parties tried to renegotiate, they quickly discovered that they no longer saw eye to eye on the terms of the sales contract. KEB had continued to post strong earnings.³⁴⁶ In addition, valuations were rising across the banking sector, and Shinhan Bank had recently agreed to take

³⁴⁰ Share Purchase Agreement Between LSF-KEB and Kookmin Bank, May 19, 2006 [Exhibit C-128].

³⁴¹ Share Purchase Agreement Between LSF-KEB and Kookmin Bank, May 19, 2006, at Sec. 9.1.2 [Exhibit C-128].

³⁴² Share Purchase Agreement Between LSF-KEB and Kookmin Bank, May 19, 2006, at Sec. 4.1.1(ii) [Exhibit C-128].

³⁴³ Share Purchase Agreement Between LSF-KEB and Kookmin Bank, May 19, 2006, at Sec. 9.1.2 [Exhibit C-128].

³⁴⁴ “Kookmin, Lone Star Likely to Extend KEB Sales Contract,” *Korea Times*, September 17, 2006 [Exhibit C-141].

³⁴⁵ “Kookmin, Lone Star Likely to Extend KEB Sales Contract,” *Korea Times*, September 17, 2006 [Exhibit C-141].

³⁴⁶ See Statement of Facts, Sec. III.B. 4.

over the once-beleaguered LG Card for a staggering \$7.5 billion, the largest banking acquisition in Korean history.³⁴⁷ LSF-KEB felt that the purchase price should be increased to reflect the bank's improved finances and the positive trends in the market, but Kookmin was pressing to lower the price.³⁴⁸ Seeing little advantage to remaining under contract with Kookmin and convinced that they would soon be able to command better financial terms as KEB's fortunes continued to rebound, LSF-KEB terminated the contract on November 23, 2006.³⁴⁹

190. After the Kookmin transaction collapsed, LSF-KEB was again approached by DBS about the possibility of acquiring its stake in KEB. The negotiations, however, were short-lived: DBS was not willing to go far without at least informal assurances from the FSC regarding its eligibility to acquire the bank, which the FSC refused to provide.³⁵⁰ DBS abandoned its efforts shortly thereafter.³⁵¹

3. Investigatory Agencies Engage in a Campaign of Harassment

191. In the meantime, Lone Star had become the target of a slew of investigations launched by Korean government agencies in response to complaints filed by Spec Watch and Lone Star's opponents in the National Assembly. These investigations stemmed from ever-evolving, but all baseless, allegations that Lone Star (i) conspired with KEB and Korean regulators to manipulate KEB's financial condition to allow LSF-KEB to qualify as a majority shareholder of KEB and to justify its paying an allegedly below-market price for the bank, and

³⁴⁷ "Card Takeover Deal Called Korea's Largest," *New York Times*, August 17, 2006 [Exhibit C-139].

³⁴⁸ Thomson Witness Statement at para. 43 [Exhibit CWE-007].

³⁴⁹ Notice of Termination sent by LSF-KEB to Kookmin, November 23, 2006 ("Kookmin Termination Notice") [Exhibit C-149].

³⁵⁰ Thomson Witness Statement at para. 47 [Exhibit CWE-007].

³⁵¹ Thomson Witness Statement at para. 47 [Exhibit CWE-007].

(ii) worked in concert with KEB managers to manipulate the stock price of KEB Card before rescuing it in order to acquire it a lower price.³⁵²

192. These probes took a toll on operations at KEB. As Mr. Wacker explains, “For months, KEB had an entire floor of its headquarters devoted to accommodating various investigations, and numerous bank employees spent countless hours in interviews and responding to document requests.”³⁵³

193. These day-to-day intrusions were in addition to the regulatory uncertainty surrounding the bank’s future ownership—uncertainty that hampered KEB management’s ability to run the bank effectively and develop long-term strategies.³⁵⁴ For instance, regulatory uncertainty slowed down KEB’s plans to expand operations in China, as Chinese regulators refused to approve branch expansions while the KEB sale was pending.³⁵⁵ It also hampered KEB’s ability to position itself to take advantage of the ever-changing regulatory environment.³⁵⁶ As Mr. Wacker explains, “because of the delays in the regulatory decision-making and the resulting failed transactions, KEB was forced to operate in a ‘strategic limbo’ that exacted a significant toll on the bank and our employees. Multiple initiatives were affected by these delays and false starts.”³⁵⁷

³⁵² See Interim Report on Results of Investigation into Illegal Sale of Korea Exchange Bank and etc., The Supreme Prosecutors’ Office, December 7, 2006 (“SPO Interim Report”), at 5 [Exhibit C-150].

³⁵³ Wacker Witness Statement at para. 35 [Exhibit CWE-008].

³⁵⁴ Wacker Witness Statement at paras. 64, 67-68 [Exhibit CWE-008].

³⁵⁵ Wacker Witness Statement at para. 67 [Exhibit CWE-008].

³⁵⁶ Wacker Witness Statement at paras. 65-68 [Exhibit CWE-008].

³⁵⁷ Wacker Witness Statement at para. 64 [Exhibit CWE-008].

a. The Board of Audit and Inspection

194. The BAI is an independent agency charged with auditing the accounts and expenditures of the national government and reviewing the performance and operations of various government agencies.³⁵⁸ After carrying out its annual audit, the BAI reports its findings to the President and the National Assembly. As Korea's supreme auditing arm, the role of the BAI has grown in importance over the course of the country's democratic era.³⁵⁹

195. On March 4, 2006, at the request of the National Assembly, the BAI launched an audit into the KEB acquisition.³⁶⁰ The audit focused on the bank's BIS ratio and the allegation that the ratio had been manipulated in 2003 in order to facilitate Lone Star's purchase of a controlling stake in KEB. A flurry of summons were issued, and over the ensuing months the BAI interrogated numerous policymakers, regulators, and bank officials. Following its audit, the BAI issued interim and final reports in June 2006 and March 2007 respectively.³⁶¹ Although the reports were critical of the events surrounding the acquisition, they found no wrongdoing on the part of Lone Star. Once the BAI announced its interim findings, it turned over the investigation

³⁵⁸ Board of Audit and Inspection Act (Act No. 9399, January 2009) [Exhibit C-330].

³⁵⁹ Policy Recommendations for the Incoming Lee Myung-bak Government, Seoul Financial Forum, February 1, 2008 [Exhibit C-332].

³⁶⁰ See Board of Audit Inspection of Korea Report on Sale of Korea Exchange Bank: Summary of Audit and Result, March 12, 2007 [Exhibit C-152]; Minutes of the National Assembly Plenary Meeting, March 2, 2006 [Exhibit C-108].

³⁶¹ Board of Audit Inspection of Korea Report on Sale of Korea Exchange Bank: Summary of Audit and Result, March 12, 2007 [Exhibit C-152]; "Fact-Finding Audit Regarding Sale of KEB - Announcement of Interim Audit Finding," BAI Press Release, June 19, 2006 [Exhibit C-134]; "Supplementary Material on the KEB Sale Progress," BAI Press Release, June 19, 2006 [Exhibit C-133]; "Distribution of Explanatory Material on KEB," MOFE Press Release, June 20, 2006 (Immediately after the BAI press release, MOFE issued explanatory material in order to rebut its position) [Exhibit C-331]. "Audit Result of the Progress in the Sale of KEB," BAI Press Release, March 12, 2007 [Exhibit C-337].

to the SPO, which had already commenced an investigation based on criminal complaints filed by the National Assembly.³⁶²

b. The Supreme Prosecutor's Office

196. The SPO is the most powerful prosecutorial office in Korea. On March 7, 2006, at the behest of the National Assembly, Spec-Watch, the NTS, and the FSS, the SPO launched a full-scale investigation into allegations of wrongdoing surrounding Lone Star's 2003 purchase of KEB and the subsequent merger of KEB Card.³⁶³ As relevant to this dispute, the investigation focused on two main components: (i) suspicion of wrongdoing surrounding the 2003 sale of KEB to Lone Star, and (ii) suspicion of stock price manipulation in connection with the KEB Card merger.³⁶⁴

197. The size and scope of the SPO's investigation was unprecedented. The SPO formed a massive investigation team comprised of 20 prosecutors and 80 investigators.³⁶⁵ Prosecutors summoned and interrogated some 630 people, including the head of the BAI, the former FSC Chairman, the Minister of Finance and Economy, and anyone with even remote connection to the KEB acquisition.³⁶⁶ The SPO searched 91 sites over the course of four months

³⁶² Interim Report on Results of Investigation into Illegal Sale of Korea Exchange Bank and etc., Supreme Prosecutors' Office, December 7, 2006 ("SPO Interim Report"), at 9 [Exhibit C-150].

³⁶³ SPO Interim Report [Exhibit C-150]; "Prosecutorial Proposal on the 5 Suspicions Surrounding Lone Star's Acquisition of KEB," National Assembly Committee Minutes, February 27, 2006 [C-307].

³⁶⁴ A third component of the investigation concerned suspicion of wrongdoing relating to the adjustments of yield rates of certain asset-backed securities. Board of Audit Inspection of Korea, Fact-Finding Audit Regarding Sale of Korea Exchange Bank: Announcement of Interim Audit Findings, June 19, 2006 ("BAI Interim Report") [Exhibit C-131].

³⁶⁵ SPO Interim Report at 10 [Exhibit C-150].

³⁶⁶ SPO Interim Report at 10 [Exhibit C-150].

and seized a total of 920 boxes of documents and approximately 10,800 gigabytes of electronic data.³⁶⁷

198. According to the SPO's December 2007 report, the SPO claimed that its initial investigation had yielded evidence to support many of the allegations in the various criminal complaints. First, with respect to the 2003 KEB acquisition, the SPO claimed to have evidence that MOFE's Dr. Yang-ho Byeon conspired with then President of KEB Kang Won Lee to manipulate financial data so that KEB's shares would be sold to LSF-KEB at an unreasonably low price.³⁶⁸ Second, with respect to the KEB Card merger, the SPO claimed to have evidence that LSF-KEB conspired with KEB to bring the KEB Card share price down so that KEB could merge with the credit card subsidiary at a favorable price.³⁶⁹

(i) *Allegations of Wrongdoing Relating to the KEB Acquisition*

199. Notwithstanding the massive scale of the investigation, by the end of 2006, the SPO had indicted only four individuals—Dr. Yang-ho Byeon, Mr. Kang-won Lee, Mr. Dal-yong Lee, Mr. Jong-sun Ha (not one a representative of Lone Star)—on charges of wrongdoing in connection with the 2003 KEB acquisition. All four defendants were put through extraordinarily trying prosecutions, yet ultimately years later were acquitted of all charges relating to the KEB acquisition.³⁷⁰

200. Among all the public officials who were attacked for taking action perceived as favorable to Lone Star, Dr. Byeon's experience was by far the most harrowing. As the senior

³⁶⁷ SPO Interim Report at 9-12 [Exhibit C-150].

³⁶⁸ SPO Interim Report at 30 [Exhibit C-150].

³⁶⁹ SPO Interim Report at 5 [Exhibit C-150].

³⁷⁰ See Byeon Decision [Exhibit C-208].

MOFE official involved in LSF-KEB's original 2003 acquisition of KEB, Dr. Byeon faced intense scrutiny from investigators over his relationship with Lone Star and his conduct in the months leading up to the acquisition.³⁷¹ Dr. Byeon was eventually charged with several counts of wrongdoing relating to the acquisition, and served nearly 300 days in jail—before being acquitted at trial.³⁷²

201. Although the SPO and BAI voiced “suspicions” that Lone Star officers were somehow involved in the improprieties allegedly committed by Dr. Byeon and Messrs. Lee, Lee, and Ha, following months of probing, the SPO was unable to implicate Lone Star in any criminal conduct. This was clearly the correct outcome as the alleged conspiracy the prosecutors had conceived of was implausible. As Mr. Grayken explains, “It would have been impossible for Lone Star to induce so many different parties—the Ministry of Finance and Economy, the bank regulators, independent auditors, bank management, and KEB’s other major shareholders, Commerzbank, KEXIM, and the BOK—to have KEB’s shares sold to LSF-KEB at a below market price.”³⁷³ In any case, as Mr. Grayken explains, Lone Star did not pay a “fire sale” price for KEB. In fact, the price it offered was significantly higher than the market price at the time, and “the market price itself did not accurately reflect KEB’s truly distressed situation.”³⁷⁴

202. This result was deeply embarrassing for the SPO, and the setback only further motivated the prosecutors, causing them to ramp up efforts to link Lone Star (by way of Paul

³⁷¹ “‘Byeon Yangho Syndrome’ of the Financial Bureaucrats,” *Donga Daily Newspaper*, November 16, 2011 [Exhibit C-273].

³⁷² Byeon Decision [Exhibit C-208].

³⁷³ Grayken Witness Statement at para. 17 [Exhibit CWE-002].

³⁷⁴ Grayken Witness Statement at para. 16 [Exhibit CWE-002].

Yoo) to the separate allegations of wrongdoing surrounding the merger with KEB Card.³⁷⁵ The prosecutors seemed resolved to see someone associated with Lone Star stand trial, and Paul Yoo, the most senior Lone Star official in Korea (after Steven Lee left the country) became their target.³⁷⁶

(ii) *Allegations of Stock Price Manipulation Relating to KEB Card Merger*

203. On October 31, 2006, the SPO asked the the Seoul Central District Court to issue a detention warrant for Paul Yoo, the former head of LSAK, and arrest warrants (for questioning) for three other LSF-KEB-appointed directors on KEB's Board at the time of the merger—Messrs. Ellis Short, Michael Thomson, and Steven Lee. On November 3, 2006, the court issued the arrest warrant for Mr. Lee, but, in an embarrassment for the SPO, the court denied the warrants for Messrs. Short, Thomson and Yoo.³⁷⁷ Prosecutors resubmitted the requests for the three warrants that same day.³⁷⁸

204. Three days later, in a startling display of prosecutorial overreach, the SPO circulated a mass email to thousands of Korean journalists, academics, and lawyers criticizing the District Court's decision.³⁷⁹ After the court denied the warrant requests for a second time on

³⁷⁵ Grayken Witness Statement at para. 29 [Exhibit CWE-002].

³⁷⁶ Thomson Witness Statement at para. 45 [Exhibit CWE-007].

³⁷⁷ SPO Interim Report at 15 [Exhibit C-150].

³⁷⁸ SPO Interim Report at 15 [Exhibit C-150].

³⁷⁹ Supreme Prosecutors Office Global Email, November 6, 2006 [Exhibit C-146]; *see also* "Urgent Report on Pending Issue (Supreme Court) - Conflicts with Prosecution Concerning Dismissal of Arrest Warrant for Lone Star; Standard for Dismissal of Arrest Warrant," National Assembly Committee Minutes, November 17, 2006 ("National Assembly Minutes, "Urgent Report," November 17 2006") (The Court submits a Report to the National Assembly on the refusal of issuance of arrest warrant in relation to the Lone Star case) [Exhibit C-147].

November 7, 2003, the prosecutors tried a third time on November 15, this time successfully.³⁸⁰ On November 16, 2006, the court issued arrest warrants for Messrs. Thomson and Short.³⁸¹ The SPO later indicted Paul Yoo (and KEB and LSF-KEB vicariously) for stock price manipulation in violation of the (since repealed) Securities and Exchange Act of Korea.³⁸² The pendency and evolution of that prosecution would later be frequently invoked as an excuse to delay action on Lone Star's efforts to sell its KEB shares, despite the fact that the prosecution of Paul Yoo related to an entirely different transaction and had no impact on Lone Star's acquisition of and title to KEB shares (much less on the qualifications of other prospective buyers of Lone Star's shares under the Banking Act).

G. AS A PRECAUTIONARY MEASURE, LONE STAR SELLS A BLOCK OF ITS KEB STOCK

205. Given the uncertain political climate in mid-2007, LSF-KEB thought it prudent to reduce its risk by selling some of its KEB shares on the open market, even though that meant giving up the control premium that would have attached to those shares if LSF-KEB held them and later sold them to a strategic buyer as part of a controlling block.³⁸³ On June 22, 2007, LSF-KEB sold 13.6% of the outstanding KEB shares in a block sale for \$1.28 billion.³⁸⁴

³⁸⁰ "Judges, Prosecutors Huddle over Lone Star Warrant," *Hankyoreh*, November 20, 2006 (describing informal meeting on pending case as 'inappropriate') [Exhibit C-148]; "Prosecution, Courts are Forgetting their Mission," *Hankyoreh*, November 4, 2006 [Exhibit C-145].

³⁸¹ National Assembly Minutes, "Urgent Report," November 17 2006 [Exhibit C-147].

³⁸² SPO Interim Report at 6 [Exhibit C-150].

³⁸³ Short Witness Statement at para. 25 [Exhibit CWE-006].

³⁸⁴ Myer Expert Report at table 2, figure 2 [Exhibit CWE-014].

H. FINANCIAL REGULATORS ARE PARALYZED BY THE FEAR OF PUBLIC AND POLITICAL BLOWBACK AND SEEK TO AVOID THEIR LEGAL OBLIGATIONS IN REVIEWING APPLICATIONS FROM WOULD-BE PURCHASERS OF LONE STAR'S INVESTMENT

206. After rescuing KEB and returning it to profitability, LSF-KEB spent years trying to sell its investment. While Lone Star was entangled in audits, investigations, and court battles, a series of potential acquisitions, including by HSBC and Hana, collapsed or were significantly delayed in the face of regulators' inaction. Officials at the FSC in particular claimed the delays were justified by the various ongoing legal proceedings concerning the 2003 acquisition of KEB and the subsequent merger between KEB and KEB Card. But even setting aside the fact that those proceedings were unfounded and part of a political witch hunt, there was no legal basis for withholding approval based on concerns relating to Lone Star, the seller of the shares.³⁸⁵ Delaying approval on that basis utterly defied logic.

207. As relevant to this dispute, regulatory approval of bank acquisitions is governed by two statutes: the Banking Act and the Financial Holding Companies Act of Korea (the "FHCA"). The Banking Act imposes limits on bank ownership, subject to the FSC's discretion to approve the acquisition of shares in excess of those limits.³⁸⁶ The FHCA operates in a similar fashion, except that it applies when the proposed acquirer is a financial holding company, as was the case with the proposed sale to Hana.³⁸⁷

208. For the purpose of evaluating the wrongfulness of the FSC's conduct, the distinctions between the two laws are immaterial. Under both procedures, the FSC is supposed

³⁸⁵ Park Expert Opinion at Sec. VI.a-b [Exhibit CWE-015]; Baik Expert Opinion at paras. 56-58 [Exhibit CWE-009].

³⁸⁶ Banking Act, Art. 15, Paragraphs (1), (3) [Exhibit C-048]; Baik Expert Opinion at paras. 30, 46 [Exhibit CWE-009]; Park Expert Opinion at paras. 42-43 [Exhibit CWE-015].

³⁸⁷ FHCA, Art. 16(1) [Exhibit CA-126]; Baik Expert Opinion at paras. 19, 67-68 [Exhibit CWE-009]; Park Expert Opinion at para. 72 [Exhibit CWE-015].

to focus its inquiry on the qualifications of the acquirer and the impact of the acquisition on the target bank.³⁸⁸ The characteristics of the seller, including any legal proceedings involving the seller, are wholly irrelevant to this inquiry. By using the legal proceedings against Lone Star as an excuse for delaying action on the applications by HSBC and Hana to acquire Lone Star's shares in KEB, and by refusing to act within the applicable statutory deadlines, the FSC acted outside the scope of its legal authority.³⁸⁹ As Professor Baik explains, "The FSC's decision to take account of the criminal proceedings pending against or relating to Lone Star when assessing HSBC's application for Excess Shareholding Approval was neither consistent with nor necessary to achieve the purpose of the Banking Act, and therefore fell outside the scope of the FSC's discretion."³⁹⁰

209. This Section focuses on the Banking Act and its related regulations. Specifically, it outlines the clearly prescribed limitations on the scope of the FSC's review, both with respect to the factors it may consider and the time period in which it must consider them, and then contrasts those limitations with how the FSC conducted itself in this case.

1. The Banking Act and the Scope of the FSC's Review

a. The Banking Act Requires that the FSC Review Applications for Regulatory Approval Based on the Applicant, Not the Seller

210. A potential acquirer of a significant ownership stake in a bank must first obtain approval from the FSC.³⁹¹ The FSC's role is to evaluate the qualifications of the applicant and

³⁸⁸ Park Expert Opinion at para. 48 [Exhibit CWE-015]; Baik Expert Opinion at paras. 52-53, 76 [Exhibit CWE-009].

³⁸⁹ Baik Expert Opinion at paras. 56-58, 77-80 [Exhibit CWE-009]; Park Expert Opinion at paras. 54-55 [Exhibit CWE-015].

³⁹⁰ Baik Expert Opinion at para. 58 [Exhibit CWE-009]. Professor Baik also makes a similar statement with respect to Hana. *Id.* at para. 79.

³⁹¹ Banking Act, Art. 15(3) [Exhibit C-048].

its ability to run the target bank in a safe and sound manner.³⁹² In carrying out this role, the FSC applies the clearly prescribed criteria on shareholding approval set out in the Banking Act.³⁹³ Those restrictions cover a range of factors, including the applicant's capital adequacy, the applicant's business plan, and the fitness of the applicant's managers to operate a bank.³⁹⁴ Each of these factors focuses on the applicant and its ability to operate the bank.³⁹⁵ As Professor Park explains, "In reviewing an application for Excess Shareholding Approval under the Banking Act, the FSC may only review matters relating to the purchaser of the shares," not the seller.³⁹⁶

211. There is no authority for the proposition that the FSC can withhold approval based on extraneous factors such as public opinion or "legal uncertainties" relating to the seller.³⁹⁷ All of the considerations in the Banking Act, its Enforcement Decree, and even the Annex to the Enforcement Decree (setting out detailed requirements for the agency's approval) concern the applicant and its ability to operate a bank.³⁹⁸ The reason the Banking Act focuses on the qualifications of the applicant, *i.e.*, the potential acquirer, is because the purpose of the Act is to protect the integrity of the financial system and the bank being acquired. The qualifications of the seller, particularly if the seller is selling its entire stake, has no bearing on that inquiry. No matter how suspect its legal status or dire its financial condition, a seller presents no risk to the

³⁹² Park Expert Opinion at para. 48 [Exhibit CWE-015]; Baik Expert Opinion at para. 52 [Exhibit CWE-009].

³⁹³ Banking Act, Art. 15(5) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 20,331, October 23, 2007), Art. 5 and its Annex Table thereto [Exhibit CA-096]; Baik Opinion at para. 52 [Exhibit CWE-009]; Park Expert Opinion at para. 52 [Exhibit CWE-015].

³⁹⁴ FSS Handbook at 48-49 [Exhibit C-039].

³⁹⁵ Park Expert Opinion at para. 20 [Exhibit CWE-015]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 20,331, October 23, 2007), Art. 5 and its Annex Table thereto (setting out detailed requirements for the agency's approval of applications for Excess Shareholding) [Exhibit CA-906].

³⁹⁶ Park Expert Opinion at para. 20 [Exhibit CWE-015].

³⁹⁷ Park Expert Opinion at para. 54 [Exhibit CWE-015]; Baik Expert Opinion at para. 53 [Exhibit CWE-009].

³⁹⁸ Park Expert Opinion at para. 47 [Exhibit CWE-015]; Baik Expert Opinion at para. 52 [Exhibit CWE-009].

solvency or integrity of the bank once it has disposed of its shares, and for this reason the characteristics of the seller are wholly irrelevant to the FSC's decision to approve an application to acquire a bank.³⁹⁹

212. Any discretion the regulators may have to interpret the requirements in the Banking Act must be exercised within the limits of the statute.⁴⁰⁰ If anything, when improprieties relating to the seller come to light, the policies and principles underlying the Banking Act would dictate *expediting* regulatory approval.⁴⁰¹

b. Allegations Regarding Lone Star's Alleged Improprieties with Respect to Its Acquisition of KEB Were Irrelevant to the FSC's Decision Whether to Approve HSBC's Acquisition of the Shares.

213. Even if the alleged improprieties by Lone Star with respect to its acquisition of KEB were true (they were not, as even the BAI, the SPO, and the courts ultimately were forced to conclude), this still would not have been relevant to the FSC's decision with respect to HSBC's application to acquire shares in KEB. Those alleged improprieties did not affect the validity of Lone Star's legal title to the shares or its right to sell those shares.⁴⁰² Therefore, there was no legal issue that conceivably could have needed to be resolved before the FSC could grant approval to HSBC to acquire the shares of KEB.

214. To understand why any allegation that Lone Star acquired its shares without proper FSC approval would not affect the validity of Lone Star's title in the shares, it is helpful to understand the difference under Korean law between regulatory approval for the purpose of

³⁹⁹ Park Expert Opinion at para. 48 [Exhibit CWE-015]; Baik Expert Opinion at para. 53 [Exhibit CWE-009].

⁴⁰⁰ Park Expert Opinion at paras. 69-71 [Exhibit CWE-015]; Baik Expert Opinion at para. 57 [Exhibit CWE-009].

⁴⁰¹ Beard Expert Opinion at para. 22 [Exhibit CWE-013].

⁴⁰² Park Expert Opinion at paras. 18-19, 31 [Exhibit CWE-015].

giving effect to a regulation (*heo-ga*) and regulatory approval for the purpose of giving effect to the underlying transaction (*in-ga*).⁴⁰³ Approval of excess shareholding under Article 15 of the Banking Act is a *heo-ga* regulation. It is a regulation that has no bearing on the underlying validity of the conduct being regulated.⁴⁰⁴ The Banking Act does not call for the invalidation of the ownership of shares acquired in violation of Article 15.⁴⁰⁵ To the contrary, it provides for penalties like restrictions on voting rights and mandatory disposal orders,⁴⁰⁶ which implicitly recognizes the *validity* of the title to such shares.⁴⁰⁷ As Professor Park observes, “There would be no need to restrict voting rights or order the disposition of shares unless the shareholder’s initial acquisition and ownership of those shares were legally valid.”⁴⁰⁸ Since approval under the Banking Act is not necessary to perfect a private transfer of shares, alleged concerns over whether LSF-KEB properly obtained the FSC’s approval when it acquired KEB in 2003 should never have figured into the FSC’s decision-making on applications by subsequent acquirers to buy the shares.⁴⁰⁹

⁴⁰³ Park Expert Opinion at paras. 26-27 [Exhibit CWE-015].

⁴⁰⁴ Park Expert Opinion at para. 28 [Exhibit CWE-015].

⁴⁰⁵ Park Expert Opinion at paras. 28, 31 [Exhibit CWE-015].

⁴⁰⁶ Banking Act, Art. 16(4) and (5) [Exhibit C-048]; Park Expert Opinion at para. 39 [Exhibit CWE-015].

⁴⁰⁷ This is by design: Since the legislative purpose of the Banking Act—protecting the financial soundness of the target bank—could be achieved by more modest means, either by restricting the offending shareholder from exercising his voting rights or by ordering him to sell shares held in excess of the statutory limit, the FSC was never given authority to take more draconian measures. Park Expert Opinion at para. 40 [Exhibit CWE-015].

⁴⁰⁸ Park Expert Opinion at para. 28 [Exhibit CWE-015]. The Supreme Court of Korea reached the same conclusion in interpreting an analogous law. *See* Act on the Structural Improvement of the Financial Industry (Law No. 6,807, December 26, 2002), Art. 24 [Exhibit CA-106]. That law is similar to Art. 15(3) of the Banking Act, in that it prohibits potential acquirers from owning bank shares in excess of a specific regulatory threshold without approval of the FSC. *See* Banking Act, Art. 15(3) [Exhibit C-048]. As the Court explained in Case No. 2003Da5337, “a financial institution’s ownership of shares in another company even if acquired without a prior FSC approval in violation of the above [provision] cannot be viewed as being so markedly contrary to social or moral order that the legal effect of such ownership should be denied as a matter of private law. . . .” Supreme Court Judgment, Case No. 2003Da5337, November 27, 2003 [Exhibit C-060].

⁴⁰⁹ Park Expert Opinion at para. 54 [Exhibit CWE-015]. Even if investigators could have substantiated the most serious allegations against LSF-KEB—that it obtained approval through corrupt and fraudulent means—the initial

In all cases, Mr. Beard explains, “the focus is on the buyer and whether the buyer will be able to ensure the safety and soundness of the bank....”⁴¹⁴

217. In the same way, if a bank or its shareholder breaks the law, the appropriate remedy under U.S. law is a fine or penalty, not withholding approval of an application by a different entity to acquire the bank.⁴¹⁵ Withholding approval of an acquisition would be particularly absurd if the penalty were an order to dispose of the shares. As Mr. Beard explains, “it was inappropriate, in my opinion, for the FSC to prevent Lone Star from selling its shares pending a court determination, when in fact, a court determination against Lone Star would have resulted in a request for Lone Star to sell its shares anyway.”⁴¹⁶ Indeed, Mr. Beard goes even further, reasoning that “if anything, such concerns would be a reason for expediting, not delaying, approval.”⁴¹⁷

2. The Banking Act Imposes Strict Deadlines for the FSC to Decide on an Application to Acquire a Bank

218. The FSC must decide an application for Excess Shareholding Approval within the 30 day statutory-review period set out in the Banking Act.⁴¹⁸ Under Article 19 of the Administrative Procedures Act of Korea (“APA”), the 30-day review period can be renewed—but only once, and then only if the agency promptly notifies the applicant of the reason for

⁴¹⁴ Beard Expert Opinion at para. 38 [Exhibit CWE-010].

⁴¹⁵ Beard Expert Opinion at para. 47 [Exhibit CWE-010].

⁴¹⁶ Beard Expert Opinion at para. 45 [Exhibit CWE-010].

⁴¹⁷ Beard Expert Opinion at para. 31 [Exhibit CWE-013].

⁴¹⁸ Banking Act, Art. 15(4) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 20,331, October 23, 2007), Art. 4-3 [Exhibit CA-096]; Park Expert Opinion at para. 57 [Exhibit CWE-015]; Baik Expert Opinion at paras. 33 and 54 [Exhibit C-009]. In 2009, the Bank Act was amended to extend the statutory review period to 60 days and to permit the period to be tolled anytime the agency determines it needs to supplement the “defects of an application.” The period can also be tolled in certain cases where criminal proceedings are pending against “the applicant, etc.” It appears this amendment was directed at LSF-KEB.

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

delay.⁴¹⁹ If regulators delay approval without cause and knowing that the delay is likely to result in the termination of the transaction, the delay is tantamount to a denial, and under the right circumstances (a finding of “substantive illegality”) may be interpreted as such.⁴²⁰

219. The FSC historically has had no difficulty meeting these requirements. As the chart below illustrates, the FSC invariably approves bank acquisitions within the time period prescribed in the Banking Act, and, although the data is limited, the agency appears to be equally timely in reviewing applications under similar laws such as the FHCA.

Applicant	Seller	Target	Days of Review Period⁴²¹	Remarks
Commerzbank	Korea Exchange Bank (32.39%)	Korea Exchange Bank	Approximately 20 days (May 28, 1998 at the earliest to July 24, 1998)	Banking Act
KEXIM	Not Applicable (Issuance of new shares)	Korea Exchange Bank	Approximately 42 days (February 5, 1999 at the earliest to April 5, 1999)	Banking Act (Indirect investment by Bank of Korea through Export Import Bank of Korea)
Goldman Sachs Private Equity	Kookmin Bank (17.066%)	Kookmin Bank	Approximately 45 days (April 12, 1999 at the earliest to June 11, 1999)	Banking Act
Newbridge Capital	Korea Deposit Insurance Corporation (“KDIC”)	Korea First Bank	Approximately 18 days (December 1, 1999 at the earliest to December 24, 1999)	Banking Act
Allianz AG	Hana Bank (12.36%)	Hana Bank	Approximately 15 days (February 19, 2000 to March 10, 2000)	Banking Act
Carlyle, JP Morgan	KorAm Bank (Subscription of newly issued DR)	KorAm Bank	Approximately 18 days (August 16, 2000 to September 8, 2000)	Banking Act
Shinhan Financial Holdings	KDIC	Chohung Bank	Approximately 31 days (July 25, 2003 to September 5, 2003)	Authorization on acquisition of a financial company as a subsidiary of a Financial Holding Company (FHCA Article 16)

⁴¹⁹ Administrative Procedures Act (Law No. 5,241, December 31, 1996), Art. 19(3) [Exhibit C-310]; Park Expert Opinion at para. 56 [Exhibit CWE-015].

⁴²⁰ Park Expert Opinion at para. 63 [Exhibit CWE-015].

⁴²¹ Calculated in terms of business days (excluding holidays).

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

Lone Star	KEXIM, Commerzbank and Korea Exchange Bank (new shares)	Korea Exchange Bank	Approximately 19 days (September 2, 2003 to September 26, 2003)	Banking Act
Citibank N.A.	Carlyle, JP Morgan	KorAm Bank (renamed as Citibank Korea Inc.)	Approximately 8 days (March 17, 2004 to March 26, 2004)	Banking Act
Standard Chartered Bank	Newbridge Capital, KDIC	Korea First Bank (renamed as SC First Bank)	Approximately 28 days (March 9, 2005 to April 15, 2005)	Banking Act
Hana Financial Holdings	Lone Star	Korea Exchange Bank	Approximately 295 days (December 13, 2010 to January 27, 2012)	Authorization on acquisition of a financial company as a subsidiary of a Financial Holding Company (FHCA Article 16)

220. Since 1998, the FSC has approved 11 applications for Excess Shareholding Approval under the Banking Act and FHCA.⁴²² Without exception, each application was approved within two months of the date it was submitted. In several cases, approval came sooner, often within the first month. There is, therefore, no precedent for delays beyond 60 days (the original 30-days plus one renewal period), much less delays lasting nine months (the unapproved HSBC transaction) or thirteen months (the Hana transaction).

3. The FSC Had Publicly Acknowledged the Limits of Its Authority to Review Applications to Acquire a Bank, But Cast Those Limitations Aside When It Came Time to Review HSBC's and Hana's Applications

221. As explained above, there are two key limitations on the FSC's legal authority. First, it must focus its review on the buyer's qualifications to operate the bank effectively; the seller is of no consequence to the FSC. Second, it must act on an application before the statutory deadline. In this case, none of the FSC's actions reflected an appreciation for these rules. Rather, the FSC operated in complete disregard of the law, showing itself to be erratic, unprincipled, and

⁴²² The total number is actually 12, but Claimants were unable to find complete information for Woori Bank's March 2003 acquisition of Kwangju Bank and Kyongnam Bank, so the transaction was left out of the data set. Also excluded were approvals relating to forced mergers under Art. 10 of the Act on Structural Improvement of Financial Industry. See Act on Structural Improvement of Financial Industry, Art. 10 [Exhibit CA-106].

highly sensitive to changes in the political environment. Indeed, as detailed in this Section, the FSC routinely changed its position on LSF-KEB's sale of KEB as the political winds swirled.

222. Surprisingly enough, it was the financial regulators who first acknowledged the limits of the FSC's statutory authority. The Chairman of the FSC stated in 2006 that the FSC could "neither force nor advise a majority shareholder of KEB to adjust the timeline for selling its shares," adding that any government agency that issued such an order "might . . . become a laughing stock in the global market."⁴²³ That was in February 2006, well before the Lone Star controversy reached the height of its intensity. Chairman Yoon reiterated this point in November 2006, explaining that the "government cannot restrict the agreement between Lone Star and Kookmin Bank . . . as it is a practice under private autonomy. [T]he stock price manipulation issue surfaced after Lone Star became the largest shareholder of KEB, so those two issues are not directly related to each other."⁴²⁴

223. But as the political environment changed, so too did the FSC's position. In June 2007, less than a year after dismissing the suggestion as a mockery, the FSC stated that the approval process could indeed be put on hold until the completion of the Paul Yoo criminal proceeding relating to KEB's merger with KEB Card.⁴²⁵ Months later, in parallel with a leadership change in March 2008, the FSC flipped once more, criticizing the "passive" approach of the previous administration and signaling its intention to move forward with the approval

⁴²³ Statement by Chairman of FSC, Jeung-hyun Yoon, Minutes of the State Affairs Committee Meeting, February 16, 2006, at 17 [Exhibit C-104].

⁴²⁴ "FSC Chairman Yoon Says Agreement between Lone Star and Kookmin Cannot be Restricted." *Hankook Daily Newspaper*, November 1, 2006 [Exhibit C-338]; Minutes of the State Affairs Committee's Inspection on the FSC and FSS, November 1, 2006, at 50 [Exhibit C-344].

⁴²⁵ "Remarks by the Vice Chairman of the FSC, Kwon Hyuk-se FSC, Putting the Brakes on Lone Star's Early Sale of KEB," *Money Today*, June 26, 2007 [Exhibit C-156]; "KEB Sale will Take a While, Senior Regulator Says," *The Korea Herald*, June 27, 2007 [Exhibit C-339].

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

process without regard to the status of the criminal proceedings.⁴²⁶ The FSC reversed course again only two months later, in June 2008, after a politically debilitating experience over imports of U.S. beef, insisting that it had no choice but to “consider public sentiment” in handling the case, only to later concede that LSF-KEB’s eligibility as a majority shareholder and the approval of KEB’s potential acquirer are “legally speaking ... two different issues.”⁴²⁷ The government’s vacillation is illustrated by the public statements set out in the chart below:

KOREAN GOVERNMENT’S CHANGING VIEWS		
	Government calls for delay	Government sees no reason to delay
Feb 06		<ul style="list-style-type: none"> ● <u>FSC Chairman, Jeung-hyun Yoon</u>: “[T]here are no legal grounds to stop the sales process. In addition, the government authorities can neither force nor advise a majority shareholder of KEB to adjust the timeline for selling its shares... if the Korean government, politicians or relevant authorities took that kind of action against a foreign majority shareholder, Korea might be seriously misunderstood and become a laughing stock in the global market.” (February 16, 2006) [Exhibit C-104] ● <u>Deputy Finance Minister, Kim Seok-dong</u>: “We [the government] don’t see any legal grounds to suspend the sale process. The matter is entirely up to Lone Star.” (February 21, 2006) [Exhibit C-474] ● <u>Deputy Prime Minister and MOFE Minister, Han Duck-soo</u>: “It does not make sense by global standards that Lone Star’s sale of KEB should be postponed because Lone Star is expected to earn KRW 3 trillion from such sale.” (February 23, 2006) [Exhibit C-126]
Dec 06 ~ Jan 07	INDICTMENT OF BYEON YANG-HO, LEE KANG-WON AND LEE DAL-YONG (DECEMBER 7, 2006) INDICTMENT OF PAUL YOO (JANUARY 26, 2007)	

⁴²⁶ “A Step Forward in the Sale of KEB and Privatization of KDB,” *Yonhap Infomax*, March 20, 2008 [Exhibit C-181]; “Chairman of the FSC, Chun Kwang-woo, FSC will Actively Resolve the Lone Star Issue,” *Maeil Business Newspaper*, April 24, 2008 [Exhibit C-182]; “KEB Sell-off Needs to Accelerate: FSC Chairman,” *Financial News*, April 24, 2008 [Exhibit C-183].

⁴²⁷ “Chairman of the FSC, Public Sentiment Must be Considered in KEB Sale,” *Money Today*, June 5, 2008 [Exhibit C-186]; “Public Sentiment is Crucial in KEB Sale,” *The Korea Herald*, June 6, 2008 [Exhibit C-187]; “Withdrawal of Chairman of FSC Chun Kwang-woo’s Original Position,” *Asia Economy*, June 25, 2008 [Exhibit C-192]; “Lone Star Cleared of Stock Manipulation,” *The Korea Herald*, June 25, 2008 (stating that “despite the not-guilty ruling at the second trial, there remain legal proceedings including the prosecution’s appeal. At this point, it is inappropriate to proceed with steps necessary for the KEB sale.”) [Exhibit C-191].

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

KOREAN GOVERNMENT'S CHANGING VIEWS		
	Government calls for delay	Government sees no reason to delay
June 07 ~ Oct 07	<ul style="list-style-type: none"> ● <u>FSC Vice Chairman, Kwon Hyuk-se</u>: "Lone Star will have to obtain the approval of the regulatory authorities in case it sells its remaining 51% interest in KEB to a strategic investor," adding, "we expect that it will take a significant time for Lone Star to sell KEB." (June 27, 2007) [Exhibit C-156] ● <u>FSC Chairman, Yoon Jeung-hyun</u>: "The administration cannot take any measure with respect to the issue for which court proceedings are underway. We will wait for the result of the court proceedings." (July 5, 2007) [Exhibit C-473] ● <u>Deputy Prime Minister and MOFE Minister, Kwon O-Kyu</u>: "The court will decide whether all legal procedures were met...so I think the FSC should decide after the [court's] decision." (October 10, 2007) [Exhibit C-166] 	
Dec 07	MYUNG-BAK LEE WINS PRESIDENTIAL ELECTION (DECEMBER 19, 2007)	
Jan 08 ~ Apr 08		<ul style="list-style-type: none"> ● <u>MB Lee Presidential Transition Committee</u>: "The Presidential Transition Committee ... wants to settle [the Lone Star] issue from a symbolic perspective to attract foreign investment." (January 10, 2008) [Exhibit C-175] ● <u>FSC Chairman, Jun Kwang-woo</u>: "[T]he FSC will review the possible side effects or problems that may be caused in economy and financial industry in case the sale is delayed." (March 20, 2008) [Exhibit C-181]; "I am mulling ways to find a solution to the seamless and prompt sale of Korea Exchange Bank. ... The previous government planned to wait until all legal uncertainties were cleared but we are different from them in that we will seek to find a way to resolve the issue as soon as possible in light of our plan to develop Korea into a hub of industry and finance." (April 24, 2008) [Exhibit C-183]
May 08	NATION-WIDE CANDLELIGHT DEMONSTRATIONS AGAINST THE GOVERNMENT ABOUT U.S. BEEF IMPORTS (MAY 2008)	
June 08	<ul style="list-style-type: none"> ● <u>FSC Chairman, Jun Kwang-woo</u>: "[With respect to Lone Star's sale of KEB], it is inevitable to consider public sentiment considering the current issue related to public protest against U.S. beef import." (June 5, 2008) [Exhibit C-186]; "[I]t is inappropriate to go ahead with the overall sale processes of KEB while the legal proceedings were still ongoing" (June 25, 2008) [Exhibit C-192] ● <u>FSC Spokesman Jae-hoon Yoo</u>: "Despite the not-guilty ruling at the second trial, there remain legal proceedings including the prosecution's appeal. At this point, it is inappropriate to proceed with steps necessary for the KEB sale." (June 25, 2008) [Exhibit C-191] 	

224. The picture that emerges from this bureaucratic wavering is that of an agency at the mercy of its political environment. The regulators withheld approval because they feared the professional and political consequences of taking action that might be viewed as favorable to Lone Star. In this volatile political atmosphere, the regulators understood the risks of being publicly affiliated with Lone Star, and they were particularly eager to avoid the fate of Dr. Byeon,

the once-esteemed MOFE official who was publicly vilified, jailed, and prosecuted as a result of his involvement in supporting Lone Star's 2003 rescue of KEB.⁴²⁸

225. Perhaps more immediately, regulators were concerned about retaining their jobs. In the months leading up to the 2007 presidential election, it became increasingly clear that the opposition parties leading the attack against LSF-KEB were likely to gain control of the Blue House in 2008.⁴²⁹ When the regulators said the process must be put on hold while legal proceedings are pending, they were merely echoing the position of opposition parties in the National Assembly.⁴³⁰

**I. THE POTENTIAL SALE TO HSBC COLLAPSES DUE TO THE FSC'S REFUSAL TO
MAKE A DECISION ON HSBC'S APPLICATION FOR REGULATORY APPROVAL**

226. In September 2007, LSF-KEB contracted with HSBC to sell its 51% interest in KEB for approximately \$6 billion. Although the HSBC purchase was widely expected to meet swift approval, it was not long before the transaction became mired in uncertainty, stalled by regulatory delays and political developments in Korea that had nothing to do with HSBC's qualifications as a buyer. By September 2008, the FSC had failed to act on HSBC's application for approval for nearly nine months and the transaction collapsed.

⁴²⁸ "KEB M&A, blocked by the 'Byeon Yang-ho Syndrome'," *Edaily News*, May 12, 2011 [Exhibit C-242]; "FSC Chairman Kim Seok-dong raises the white flag to 'Byeon Yan-ho Syndrome'," *Joongang Daily*, May 12, 2011 [Exhibit C-243]; "Where is the end to 'Byeon Yangho Syndrome'," *Aju Business Daily*, May 18, 2011 [Exhibit C-244]; "Financial Authorities locked up in 'Byeon Yangho Syndrome'," *Maeil News*, June 23, 2011 [Exhibit C-248]; "'Byeon Yangho Syndrome' of the Financial Bureaucrats," *Donga Daily Newspaper*, November 16, 2011 [Exhibit C-273]; "Truth about the Sale of KEB Must be Brought to Light," *MK News*, April 5, 2007 [Exhibit C-340].

⁴²⁹ "Lee Myung-bak Smiles, While Park Geun-hye and Goh Gun are 'Bitter,'" *Hankuk Daily News*, December 29, 2006 [Exhibit C-341].

⁴³⁰ "HSBC Hits Hurdle to Korean Takeover," *Financial Times*, October 10, 2007 [Exhibit C-166]; "FSC, Cannot Approve the Sale of KEB until the Court Decisions are Out," *Yonhap News*, September 3, 2007 [Exhibit C-161]; "KEB Sale, HSBC Under Fire for Challenging Regulator," *Korea Times*, September 4, 2007 [Exhibit C-163]; Minutes of the Spokesman's Briefing on KEB, December 20, 2007 [Exhibit C-168].

227. The period that elapsed between the SPA's execution and termination was marked by sharp and erratic changes in the FSC's posture, with the prospects for regulators' approval seeming to fluctuate by the month. Former U.S. Senator Phil Gramm, who, as Vice Chairman of UBS, represented HSBC during the transaction, believes those delays by the regulators can be boiled down to politics: "In my opinion," Senator Gramm says, "Korean government officials believed that approving HSBC's application would be politically controversial, and therefore sought to distance themselves from the whole process."⁴³¹

1. The Chronology of HSBC's Failed Attempt to Acquire Lone Star's Stake in KEB Due to Regulators' Paralysis

a. August 2007 – January 2008: HSBC and LSF-KEB Enter into a Sale Agreement But the FSC Immediately Announces that It Cannot Make a Decision to Approve the Deal Due to Unrelated Legal Proceedings

228. In the summer of 2007, HSBC approached LSF-KEB to express interest in acquiring LSF-KEB's majority stake in KEB. By all accounts, this seemed like an ideal opportunity for LSF-KEB to sell its shares. For one thing, the assorted government investigations into allegations of wrongdoing surrounding the original acquisition had concluded.⁴³² No charges had been brought against LSF-KEB or its representatives, and there were no findings that could even conceivably affect LSF-KEB's ownership of its shares in the bank. Although Paul Yoo (and KEB and LSF-KEB vicariously) were still facing charges of stock price manipulation in connection with the separate KEB Card merger, Lone Star and its managers felt confident that the Yoo proceedings would not affect the HSBC approval process.

⁴³¹ Witness Statement of Senator Phil Gramm ("Gramm Witness Statement") at para. 5 [Exhibit CWE-001].

⁴³² Short Witness Statement at para. 26 [Exhibit CWE-006].

229. As opposed to the investigation into Lone Star's original acquisition of its shares in KEB, which at least had a conceivable (albeit entirely baseless) connection to LSF-KEB's status as KEB's shareholder, the Yoo investigation concerned post-acquisition events that had no bearing on LSF-KEB's ownership of its shares—much less on HSBC's qualifications as a buyer. Moreover, when HSBC applied for regulatory approval, the Yoo trial was ongoing; it would likely be months before the trial reached a verdict, and then years before any appeals could be resolved. It seemed implausible that regulators would wait until a decision in the Yoo case was final before taking action.⁴³³

230. On September 3, 2007, LSF-KEB and HSBC executed a SPA at a price of approximately KRW 6 trillion for LSF-KEB's remaining 51% interest in KEB.⁴³⁴ The agreement was subject to regulatory approval, and out of caution, the parties allowed for a generous period of eight months for HSBC to obtain approval from the various regulatory agencies.⁴³⁵ LSF-KEB understood that HSBC would make an effort to push its application through the approval process after the December 2007 presidential election.⁴³⁶ If the FSC did not approve HSBC's application by April 30, 2008, either party could terminate the sales agreement without penalty.⁴³⁷

231. However, immediately after the SPA was announced, the FSC held a press briefing in which it stated that approval of HSBC's acquisition would not be made until legal

⁴³³ Thomson Witness Statement at para. 46 [Exhibit CWE-007].

⁴³⁴ Share Purchase Agreement between LSF-KEB Holdings, SCA, and HSBC Asia Pacific Holdings (UK) Limited, September 3, 2007 [Exhibit C-162]; Wacker Witness Statement at para. 21 [Exhibit CWE-008].

⁴³⁵ Share Purchase Agreement between LSF-KEB Holdings, SCA, and HSBC Asia Pacific Holdings (UK) Limited, September 3, 2007 [Exhibit C-162]; Short Witness Statement at para. 26 [Exhibit CWE-006].

⁴³⁶ Short Witness Statement at para. 26 [Exhibit CWE-006].

⁴³⁷ Share Purchase Agreement between LSF-KEB Holdings, SCA, and HSBC Asia Pacific Holdings (UK) Limited, September 3, 2007 [Exhibit C-162].

uncertainties surrounding the Yoo proceeding were resolved.⁴³⁸ On December 17, 2007, when HSBC submitted its application for approval to acquire LSF-KEB's controlling equity stake in KEB, the FSC acknowledged receipt of the application.⁴³⁹ But three days later, an FSC spokesperson said he was unable to estimate how long approval would take, and warned that "[the FSC] is planning to conduct its examination for approval of the applications in consideration of the results of the related trial . . . [which] may take some time."⁴⁴⁰ Around the same time, the FSC sent a letter to HSBC warning of delays in the approval process.⁴⁴¹ As noted, however, the court proceedings pending against Lone Star were legally irrelevant to the FSC's consideration of HSBC's application, and were not a valid excuse for delay.

232. On December 19, 2007, GNP nominee Lee Myung-bak won the presidential election, ending a decade of progressive rule and signaling a conservative shift in Korean politics.⁴⁴² Although the GNP had been a fierce critic of Lone Star during the 2006-2007 election cycle, Lee's election was not expected to jeopardize the HSBC acquisition; in fact, it was even expected that Lee's election would facilitate the acquisition. The GNP's anti-Lone Star campaign was the work of politicians trying to get their party into office. The GNP had less use for "Lone Star-gate" now that it controlled the Blue House, and the once-fierce opposition

⁴³⁸ "FSC, Cannot Approve the Sale of KEB Until the Court Decisions Are Out," *Yonhap News*, September 3, 2007 [Exhibit C-161]; "KEB Sale, HSBC Under Fire for Challenging Regulator," *Korea Times*, September 4, 2007 [Exhibit C-163]; "HSBC Hits Hurdle to Korean Takeover," *Financial Times*, October 10, 2007 [Exhibit C-166].

⁴³⁹ "HSBC Applies for Approval for Acquisition of KEB," *Kyunhyang Daily News*, December 20, 2007 [Exhibit C-425].

⁴⁴⁰ Minutes of the Spokesman's Briefing on KEB, December 20, 2007 [Exhibit C-168]; "HSBC Applies for Approval for Acquisition of KEB," *Kyunhyang Daily News*, December 20, 2007 [Exhibit C-425]; "FSC Defers its Decision for Application," *Newspim*, December 20, 2007 [Exhibit C-170].

⁴⁴¹ "HSBC Applies for Approval for Acquisition of KEB," *Kyunhyang Daily News*, December 20, 2007 [Exhibit C-425].

⁴⁴² "The Evolution of a Man Called 'Bulldozer,'" *New York Times*, December 20, 2007 [Exhibit C-171].

party seemed to go quiet in the wake of the presidential election, even prompting Spec Watch to question the sincerity of its prior motivations.⁴⁴³

233. At any rate, President Lee had larger issues on his plate. A former CEO of Hyundai Construction & Engineering, President Lee had billed himself as a business-friendly candidate with ambitious plans for economic expansion. He was also laying the groundwork for a bilateral trade agreement with the United States, a politically challenging objective that would require strong relations with the U.S. government.⁴⁴⁴ Delays in LSF-KEB's sale of KEB would run contrary to these goals. Consistent with these sentiments, on January 10, 2008, President-elect Lee's transition team stressed that it "cannot continue to carry this issue with it," referring to the fact that the controversy "has become a hot potato" and suggesting the possibility of "an early sale to be approved."⁴⁴⁵

234. Individuals close to the transactions seemed to share the belief that HSBC was a promising deal. "HSBC was one of the largest banks in the world and had for some time been seeking to increase its market presence in Korea," Mr. Thomson explains, and "it undoubtedly had the experience and financial wherewithal to promote greater growth at KEB, and it was likely to maintain KEB's workforce without reductions in personnel."⁴⁴⁶

235. The Korean business community shared this optimism. President Lee had campaigned on the promise of restoring Korea's reputation among foreign investors, and

⁴⁴³ "Lone Star Snipers Such as Na Kyung-won and Ko Seung-duk in Silence," *Pressian*, August 12, 2008 [Exhibit C-200].

⁴⁴⁴ See Gramm Witness Statement at paras. 10-11 [Exhibit CWE-001].

⁴⁴⁵ "Financial Industry, Step to Complete the Early Sale of KEB," *Seoul Economy*, January 10, 2008 [Exhibit C-175]; Policy Recommendations for the Incoming Lee Myung-bak Government, Seoul Financial Forum, February 1, 2008, at 23-24 [Exhibit C-332].

⁴⁴⁶ Thomson Witness Statement at para. 52 [Exhibit CWE-007].

approving Lone Star's sale of KEB seemed to Lee's supporters in the business community as a logical place to start. Indeed, resolving the Lone Star case featured prominently among the list of policy recommendations prepared for the Lee Administration by the Seoul Financial Forum, an influential Korean think tank.⁴⁴⁷ Stressing that the failure to approve the KEB acquisition had undermined confidence in Korea's rule of law, the report called on the Administration to "promptly resolve" the Lone Star case.

b. January 2008 – February 2008: The FSC Continues to Refuse to Act on HSBC's Application Due to Unrelated Legal Proceedings

236. Meanwhile, Paul Yoo's criminal trial was underway in Seoul, and in January 2008, John Grayken flew to Korea to testify in Mr. Yoo's defense. Although Mr. Grayken had been warned by Mr. Yoo's defense team that the prosecutors would seek to make his visit unpleasant, and might even go so far as to detain him, Mr. Grayken concluded that the possibility that he could help Mr. Yoo obtain a well-deserved acquittal was worth the risk.⁴⁴⁸ But as feared, the prosecutors detained Mr. Grayken for questioning for more than ten days—and for up to 16 hours each day. Although Mr. Grayken was accompanied by his lawyers, they were allowed to serve only as translators and were not permitted to ask questions.⁴⁴⁹

237. The HSBC acquisition was dealt its first major setback on February 1, 2008, when the Seoul Central District Court found Paul Yoo (and, vicariously, LSF-KEB and KEB) guilty of stock manipulation in connection with KEB Card merger.⁴⁵⁰ In response to the court decision,

⁴⁴⁷ Policy Recommendations for the Incoming Lee Myung-bak Government, Seoul Financial Forum, February 1, 2008 [Exhibit C-332].

⁴⁴⁸ Grayken Witness Statement at para. 30 [Exhibit CWE-002].

⁴⁴⁹ Grayken Witness Statement at para. 31 [Exhibit CWE-002].

⁴⁵⁰ Seoul Central District Court Judgment, Case No. 2007Gohap71 and 2006Gohap1272, February 1, 2008 [Exhibit C-033]; Seoul District Prosecutor's Office, Order for LSF-KEB to Deposit Fine, February 12, 2008 [Exhibit C-345].

the FSC announced that HSBC's application to acquire LSF-KEB's shares would remain in pending status until "after the legal uncertainty is resolved."⁴⁵¹ With this statement, hopes began to fade that the FSC would take up HSBC's application before outgoing FSC Chairman Yongduk Kim left office at the end of February 2008.

c. March 2008 – April 2008: A Glimmer of Hope, Later Dashed, that the FSC Will Approve HSBC's Application

238. But March brought several encouraging developments, beginning with the KFTC's approval of the HSBC acquisition on competition law grounds, the final Korean regulatory hurdle other than the FSC.⁴⁵² Next came President Lee's appointment of Kwang-woo Chun as FSC Chairman. Given President Lee's pro-business philosophy and his transition team's recent remarks about the KEB acquisition, it was expected that Chairman Chun would take swift action on HSBC's application. In line with this view, shortly after taking office, Chairman Chun echoed the administration's position on the KEB acquisition, acknowledging the previous regulatory delays and promising that HSBC's application would "soon be approved."⁴⁵³

239. Notwithstanding these positive developments, people close to the HSBC transaction were growing impatient with the FSC. During an April 2008 business luncheon with President Lee, Senator Gramm caught President Lee off guard when he asked about the progress of the approval process. As Gramm recalls,

President Lee asked for suggestions on how he could improve the business climate in Korea. When it was my opportunity to speak, I said that approving HSBC's acquisition of KEB could improve the

⁴⁵¹ "Lone Star, at the Brink of Deal Break," *Hankyoreh*, February 1, 2008 [Exhibit C-176].

⁴⁵² "KFTC Decides HSBC's Acquisition of KEB Lacks Anti-competitive Effects," Korea Fair Trade Commission Press Release, March 5, 2008 [Exhibit C-180].

⁴⁵³ "A Step Forward in the Sale of KEB and Privatization of KDB," *Yonhap Infomax*, March 20, 2008 [Exhibit C-181].

business climate. I made it clear that, while UBS represented HSBC in the negotiations, my response was given from the perspective of what I believed was in the best interest of Korea. Korea was receiving very bad publicity for its handling of Lone Star's attempts to sell its stake in KEB, so I wanted to convey to President Lee that delaying regulatory approval any longer would only further undermine Korea's credibility with international investors.⁴⁵⁴

240. Gramm's statement was not well received. Before President Lee had a chance to respond, his staff promptly intervened to foreclose any further discussion on the matter. To Senator Gramm, this reaction provided further evidence that Lone Star remained a sensitive issue in Korean politics. As Senator Gramm explains, "it seemed clear to me that the Korean government was concerned about the political fallout of approving the acquisition because Lone Star was a politically unpopular company; and I think that the reaction I received at the luncheon reflected that attitude."⁴⁵⁵

241. The rest of April went by with no sign of action from the FSC. But on April 23, 2008, Chairman Chun fueled hopes that approval might be forthcoming: "We are putting much thought into addressing the issue as soon as possible in the most amicable way . . . the previous administration took on a 'passive' attitude, waiting until the problem solves itself. However, our attitude has changed."⁴⁵⁶ This statement was very timely, since the HSBC contract was set to expire on April 30, 2008. But with this positive signal, LSF-KEB and HSBC agreed to extend

⁴⁵⁴ Gramm Witness Statement at para. 6 [Exhibit CWE-001].

⁴⁵⁵ Gramm Witness Statement at para. 7 [Exhibit CWE-001].

⁴⁵⁶ "Chairman of the FSC, Chun Kwang-woo, FSC will Actively Resolve the Lone Star Issue," *Maeil Business Newspaper*, April 24, 2008 [Exhibit C-182]; "KEB Sell-off Needs to Accelerate: FSC Chairman," *Financial News*, April 24, 2008 [Exhibit C-183].

the contract until July 31, 2008, to give the new administration more time to complete the approval process.⁴⁵⁷

d. May 2008 – September 2008: The Deal Collapses as External Political and Legal Events Prompt the FSC to State that “Public Sentiment” Must Be Taken into Account in Assessing HSBC’s Application

242. The FSC’s delays—now totaling some 150 days’ after the application—continued through May, fueling speculation that the FSC would push back a decision on the HSBC acquisition until after the May 2008 national elections.⁴⁵⁸ Unfortunately, the political winds then shifted again. In response to President Lee’s decision to reverse Korea’s ban on U.S. beef imports, tens of thousands of Koreans converged on downtown Seoul to participate in mass rallies and candlelight vigils in opposition to the lifting of the ban.⁴⁵⁹ The ban had originally been put in place over concerns that U.S. beef was tainted with mad cow disease, and the protesters accused the Lee administration of catering to U.S. economic interests at the expense of Koreans’ public health. Although the beef issue could not have been further removed from the pending HSBC acquisition, it sapped the Lee administration’s political capital and heightened its sensitivity to accusations that President Lee was all too eager to indulge foreign (especially perceived American) economic interests.⁴⁶⁰

243. On June 5, 2008, in a clear sign that the Lee administration had backpedaled on the HSBC acquisition, FSC Chairman Chun reversed his position on the HSBC acquisition: “Considering the current issue related to public protests against US beef import[s],” Chairman

⁴⁵⁷ Amendments to Share Purchase Agreement between LSF-KEB Holdings, SCA and HSBC Asia Pacific Holdings (UK) Limited, April 29, 2008 [Exhibit C-184]; Thomson Witness Statement at para. 54 [Exhibit CWE-007].

⁴⁵⁸ Wacker Witness Statement at para. 55 [Exhibit CWE-008].

⁴⁵⁹ Wacker Witness Statement at para. 56 [Exhibit CWE-008].

⁴⁶⁰ Wacker Witness Statement at para. 56 [Exhibit CWE-008].

Chun said, “it is inevitable to consider public sentiment” in the handling of the Lone Star case.⁴⁶¹

With this statement, the FSC had abandoned the pretense that the delays were based on legal concerns (even if the legal concerns had nothing to do with the buyer). The delays were now explicitly political.

244. But in what was beginning to feel like a ping-pong match, good fortune came back around when several weeks later, the Seoul High Court on appeal found Paul Yoo not guilty of criminal conduct related to the KEB Card merger.⁴⁶² Observers universally assumed that this put an end to the “legal uncertainty” that had been blamed for the regulators’ delays. The acquittal seemed to be the necessary resolution that would allow the FSC to finally take action on HSBC’s application. LSF-KEB was thus shocked by the FSC’s announcement that, in its view, the legal uncertainty had not been resolved. According to the FSC’s press release, “even though the court of appeal had rendered a judgment finding the defendants not guilty . . . , there remain judicial proceedings, however, as the prosecutor has not yet decided whether to re-appeal.”⁴⁶³

245. As HSBC and LSF-KEB approached the end-July drop-dead date in their SPA, LSF-KEB and its representatives had to begin seriously considering the prospect that the contract would expire without any FSC action on HSBC’s application. Representatives for both parties did what they could to persuade the FSC to grant the approval. Mr. Grayken sent several letters to Chairman Kwang-woo Chun urging approval and warning that the FSC’s failure to take action

⁴⁶¹ “Chairman of the FSC, Public Sentiment Must be Considered in KEB Sale,” *Money Today*, June 5, 2008 [Exhibit C-186]; “Public Sentiment is Crucial in KEB Sale,” *The Korea Herald*, June 6, 2008 [Exhibit C-187]; “Withdrawal of Chairman of FSC Chun Kwang-woo’s Original Position,” *Asia Economy*, June 25, 2008 [Exhibit C-192].

⁴⁶² Seoul High Court Judgment, Case No. 2008No518, June 24, 2008 [Exhibit C-188].

⁴⁶³ “Regarding the Appellate Court Decision on Stock Price Manipulation by KEBCS,” FSC Press Release, June 24, 2008 [Exhibit C-189]; “FSC Delays the Approval of the Sale of KEB Shares,” *Yonhap News*, June 24, 2008 [Exhibit C-190]; “Lone Star Cleared of Stock Manipulation,” *The Korea Herald*, June 25, 2008 [Exhibit C-191].

would likely derail the HSBC acquisition.⁴⁶⁴ U.K. Prime Minister Gordon Brown sent President Lee a letter to the same effect.⁴⁶⁵

246. On July 24, 2008, one day before the FSC announced that it would resume review of HSBC's qualifications to be a major shareholder in KEB, FSC Chairman Chun met with U.S. Ambassador to Korea Alexander Vershbow.⁴⁶⁶ The details of the meeting were described in a leaked diplomatic cable from the U.S. Embassy in Seoul. Lone Star's proposed sale of its KEB stake was among the meeting's key agenda items. The tenor of the meeting was open and congenial, and Chairman Chun spoke candidly about the approval process and the reasons why it had been delayed, readily admitting that public sentiment figured prominently in the agency's decision making.⁴⁶⁷

247. Stressing the continuing sensitivity of the Lone Star issue in Korea, Chairman Chun estimated that the FSC's review would take an additional 1-2 months.⁴⁶⁸ He said regulators hoped some of the "legal uncertainties" surrounding the KEB acquisition would be resolved by then. "It would be nice," the Chairman said, "to have the initial lower court decision on the BIS-ratio understatement case as an added justification for going ahead with the sale approval."⁴⁶⁹ According to the cable, when asked how convictions in that case could

⁴⁶⁴ Letter from John Grayken to FSC Chairman Kwang-woo Jun, July 9, 2008 [Exhibit C-195]; Letter from John Grayken to FSC Chairman Kwang-woo Jun, August 8, 2008 [Exhibit C-199].

⁴⁶⁵ Grayken Witness Statement at para. 33 [Exhibit CWE-002].

⁴⁶⁶ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 [Exhibit C-426].

⁴⁶⁷ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 [Exhibit C-426].

⁴⁶⁸ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 [Exhibit C-426].

⁴⁶⁹ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 at 4 [Exhibit C-426].

conceivably affect the KEB sale, Chairman Chun smiled and said, “Well, it seems like the worst we could do is just what they want us to do”—order Lone Star to sell its shares.⁴⁷⁰ When it was pointed out that no Lone Star officials had been implicated in the “BIS-ratio proceeding,” Chairman Chun accepted the point but observed that “even if there were no clear linkage between the BIS-ratio court proceedings and allegations of wrongdoing by Lone Star, the public perception persisted.”⁴⁷¹

248. Throughout the meeting, Chairman Chun spoke of the approval process in purely political terms. He referred to the agency’s decision to resume review as a “gift for your visit,” adding that “[t]his is encouraging news for you, but I will take a hit.”⁴⁷² He said there were rifts inside the Lee Administration over the approval process and noted that some quarters “were still concerned about how to deal with negative repercussions stemming from giving a signal that the sale might eventually be approved.”⁴⁷³ Missing from the discussion was any mention of the statutory factors that govern the FSC’s review of potential acquirers.

249. As noted, on July 25—some 200 plus days after HSBC’s application and several days before the extended SPA deadline—the FSC announced its intention to “resume” its review of HSBC’s application. This was somewhat of a mixed message, however, because the agency at the same time maintained—rather inconsistently—that it would not reach a final decision until

⁴⁷⁰ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 at 4-5 [Exhibit C-426].

⁴⁷¹ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 at 5 [Exhibit C-426].

⁴⁷² FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 at 3-4 [Exhibit C-426].

⁴⁷³ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 at 3-4 [Exhibit C-426].

outstanding legal issues were resolved.⁴⁷⁴ With respect to the sale of KEB, the FSC stated that the approval process would proceed “only when” the investigation into LSF-KEB’s acquisition and the stock price manipulation proceeding are resolved.⁴⁷⁵ In conjunction with this announcement, the FSC asked HSBC to supplement its application.⁴⁷⁶ Several weeks later, on August 11, the FSC acknowledged receipt of HSBC’s supplemental materials and reiterated its intention to resume review of HSBC’s application to acquire KEB.⁴⁷⁷ Although the SPA’s drop-dead date had passed, LSF-KEB continued to plead with the regulators to approve the application.⁴⁷⁸ Finally, on August 20, the FSC informed LSF-KEB that the commissioners would call a meeting to approve the acquisition in two weeks.⁴⁷⁹

250. But by that time it was too little, too late. The damage had already been done. By that point—a year after the parties entered into the SPA and more than nine months after HSBC requested approval—the global economy was showing increasing signs of weakening and instability. As a result HSBC had grown anxious about the acquisition, and since the extended drop-dead deadline had expired, HSBC had the right to terminate the SPA at will.⁴⁸⁰ As Senator Gramm explains, the impending global financial crisis “caused massive declines in asset values, and, as a result, HSBC believed that its initial offer was inconsistent with the new economic

⁴⁷⁴ “Explanation for a Chosun Ilbo Article Titled ‘HSBC to Acquire KEB,’” FSC Press Release, July 24, 2008 [Exhibit C-197].

⁴⁷⁵ “Explanation for a Chosun Ilbo Article Titled ‘HSBC to Acquire KEB,’” FSC Press Release, July 24, 2008 [Exhibit C-197].

⁴⁷⁶ “FSC Resumes Review of KEB Sale Application,” *Asia Economy*, July 25, 2008 (FSC official states that although the agency’s review will recommence, a final decision will depend on whether legal uncertainties are cleared up.) [Exhibit C-198].

⁴⁷⁷ “Lone Star Submits Controlling Shareholder Qualification Related Materials,” FSC Press Release, September 9, 2008 [Exhibit C-082].

⁴⁷⁸ Letter from John Grayken to FSC Chairman Kwang-woo Jun, August 8, 2008 [Exhibit C-199].

⁴⁷⁹ Short Witness Statement at para. 30 [Exhibit CWE-006].

⁴⁸⁰ Amendment to Share Purchase Agreement between LSF-KEB Holdings, SCA and HSBC Asia Pacific Holdings (UK) Limited, April 29, 2008 (“Amended SPA between LSF-KEB and HSBC”) [Exhibit C-184].

realities.”⁴⁸¹ HSBC terminated the contract on September 18, 2008—three days after Lehman Brothers filed for bankruptcy in the United States.⁴⁸² Just days later, on September 22, 2008, President Lee referred to the failed negotiations as a “lost opportunity,” blaming the FSC for not being “able to make a timely decision.”⁴⁸³

e. Post-Termination Developments: The FSC’s Arbitrary Re-Opening of Lone Star’s Qualifications to Be a Major Shareholder of KEB

251. Following the termination of the HSBC contract, the FSC continued to issue requests for further information on Lone Star’s worldwide assets as part of its redetermination of whether Lone Star was an industrial conglomerate (NFBO). In April 2006, the FSC had announced that it would be revisiting LSF-KEB’s previously unchallenged status as a lawful shareholder of KEB, this time based on an expanded interpretation of “non-financial business operator” under Article 2(1)9 of the Banking Act.⁴⁸⁴ When approving LSF-KEB’s acquisition of shares in KEB in September 2003 (and later when conducting semi-annual reviews of LSF-KEB’s qualification to be KEB’s controlling shareholder), the financial regulators had never asked about Lone Star’s foreign affiliates that had no relationship to its investments in Korea. But in a departure from this practice, the regulators were now asking Lone Star to account for all

⁴⁸¹ Gramm Witness Statement at para. 8 [Exhibit CWE-001].

⁴⁸² Termination of SPA between HSBC and LSF-KEB, September 18, 2008 [Exhibit C-205]; “HSBC Terminates Contract with Lone Star”, FSS Press Release, September 19, 2008 [Exhibit C-206]. HSBC made a face-saving offer after they terminated, proposing a lower price that would be paid in stock, rather than cash, but nobody took it seriously. Thomson Witness Statement at para. 54 [Exhibit CWE-007].

⁴⁸³ “Be Puzzled by the Unexpected Statement of MB,” *Kyunghang News*, September 22, 2008 [Exhibit C-248].

⁴⁸⁴ “Regulatory Office Says It Will Begin the Review on Lone Star’s Eligibility as a Majority Shareholder,” *Yonhap News*, June 12, 2007 [Exhibit C-155]; Letter from FSS, Urging Care in Connection with Submission of Materials Which are Reviewed for Purposes of Examination of Qualification for Shareholding in Excess of Prescribed Limit by a Shareholder, May 2, 2007 [Exhibit C-342]; Letter from FSC, Request for Submission of Materials Regarding Examination of Satisfaction of Requirements for Shareholding in Excess of Prescribed Limit by a Shareholder, May 3, 2007 [Exhibit C-343]; Financial Supervisory Service, Request for Confirmation on Overseas Investments by Specially Related Persons of Lone Star Fund IV, November 27, 2007 [Exhibit C-167].

of Lone Star's global affiliates, without regard to whether they were related to the investments made in Korea by Lone Star's fund that had invested in KEB.⁴⁸⁵

252. Although regulators had originally estimated that their investigation of Lone Star's NFBO status would be complete in a month, it would ultimately drag on for several years.⁴⁸⁶ The FSC used the review of Lone Star's NFBO status as an excuse to delay approval of the HSBC acquisition. The review served no purpose other than to cater to anti-Lone Star civic groups that had for years been calling on regulators to review LSF-KEB's qualifications as a substantial shareholder in KEB.⁴⁸⁷

253. The FSC's requests for information related to its NFBO review were extensive, costly, and burdensome, involving overseas Lone Star affiliates and their assets that had no relation to LSF-KEB and KEB. Although Lone Star had made its best efforts to gather the requested documentation and respond in good faith to the FSC's inquiries, on January 2, 2009, the FSC sent a notice to Lone Star Partners IV, L.P. ("LSP IV") (the general partner of the investor partnership involved in the KEB transaction), notifying it that it would be subject to a regulatory fine for a one-week delay in submitting materials evidencing its qualification to hold an excess shareholding in KEB in September 2008.⁴⁸⁸ However, LSP IV had on September 1, 2008 requested an extension to submit these materials.⁴⁸⁹ Ignoring this request, the FSC held a

⁴⁸⁵ Letter from FSC, Request for Submission of Materials Regarding Examination of Satisfaction of Requirements for Shareholding in Excess of Prescribed Limit by a Shareholder, May 3, 2007 [Exhibit C-343].

⁴⁸⁶ "Qualification Review Result for Shareholding in Excess of Prescribed Limit of KEB," FSC Press Release, March 16, 2011 [Exhibit C-235].

⁴⁸⁷ "Civic Groups, Evaluation Required to Determine if Lone Star is a Non-Financial Business Operator," *Kyunghyang Daily News*, March 27, 2007 [Exhibit C-314].

⁴⁸⁸ See Financial Services Commission, Advance Notice of Proposed Regulatory Fine on Lone Star Fund IV, January 2, 2009 [Exhibit C-209].

⁴⁸⁹ See Letter from Lone Star Partners IV, L.P. to FSC, September 1, 2008 [Exhibit C-201]. The requested materials were submitted on September 7, less than one week after the extension request. See Lone Star Statement of Opinion

press conference the next day to announce that Lone Star could be sanctioned for its delay in complying with the FSC's information request. While the sanction would likely be a regulatory fine, such a fine would have grave implications for Lone Star because, pursuant to the Banking Act, receipt of the fine would constitute a "flaw" in Lone Star's qualification to remain a major shareholder in KEB.⁴⁹⁰ That, in turn, would mean that the FSC could order Lone Star to dispose of its shares in KEB.⁴⁹¹

254. LSP IV immediately submitted to the FSC two opinions objecting to this regulatory fine.⁴⁹² In these opinions, LSP IV argued that Lone Star's overseas affiliates are irrelevant to its shareholding in KEB and fall outside the scope of the NFBO rule and that the actions contemplated by the FSC were gravely disproportionate to the alleged violation of several days' delay in submitting the requested documentation.⁴⁹³ Ultimately, the proceeding remained open without action by the FSC and was eventually rendered moot by LSF-KEB's sale of its shareholding to Hana.

2. The FSC Violated Korean Law in Refusing to Act on HSBC's Application

255. As noted, Korean law required the FSC (i) to complete its review of HSBC's application within 30 days (or, if extenuating circumstances demand it, 60 days), and (ii) to limit

at 10 [Exhibit C-210]; Supplemental Opinion by Lone Star Partners IV, L.P., February 3, 2009 ("Lone Star Supplemental Opinion"), at 2 [Exhibit C-211].

⁴⁹⁰ See, e.g., "S. Korea to Consider Fining Lone Star Funds," *International Herald Tribune*, September 2, 2008 [Exhibit C-202]; "Lone Star May Face Order to Sell KEB Shares—Regulator," *Reuters*, September 2, 2008 (noting analysts' views that the FSC's regulatory ruling "could prompt HSBC . . . to seek to lower the \$6.3 billion it offered for [LSF-KEB's] majority stake.") [Exhibit C-203]; Banking Act, Art. 15(5) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 17,717, August 21, 2002), Art. 5 and its Annex Table thereto [Exhibit C-304].

⁴⁹¹ See Lone Star Statement of Opinion at 10 [Exhibit C-210]; Lone Star Supplemental Opinion at 2 [Exhibit C-211].

⁴⁹² Lone Star Statement of Opinion [Exhibit C-210]; Lone Star Supplemental Opinion [Exhibit C-211].

⁴⁹³ Lone Star Statement of Opinion at 7 [Exhibit C-210].

its review to the qualifications of the acquirer.⁴⁹⁴ The FSC failed to comply with either of these requirements in reviewing HSBC's application.

a. The FSC Exceeded the Time Periods Required by Law for
Reviewing HSBC's Application

256. The FSC violated the 30-day processing period by failing for nine months to take action on HSBC's application (and the nine-month period ended only due to the withdrawal of HSBC). The FSC never notified HSBC of the delay as required under the Banking Act,⁴⁹⁵ nor did it offer a legal basis for tolling the review period. Under the mandatory review period, the acquisition should have been approved by the middle of January—or mid-February at the latest. Moreover, even if the FSC had requested supplemental materials, as Professor Park points out, the evidence shows “that the real reason for the FSC's delay was the fact that criminal proceedings relating to Lone Star were pending.”⁴⁹⁶

257. According to the FSC, the 30-day review period had not yet expired when HSBC sent its notice of termination on September 18, 2008.⁴⁹⁷ But for that to be true, the FSC would have to establish that the review period was tolled between December 2007 and August 2008, even though the FSC had not (i) notified HSBC of a delay in the review process, (ii) identified deficiencies in the application, or (iii) requested supplemental materials. Even if the FSC had

⁴⁹⁴ Banking Act, Art. 15(4) and (5) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 20,331 October 23, 2007), Art. 4-3 [Exhibit CA-096]; Park Expert Opinion at para. 62 [Exhibit C-015]; Baik Expert Opinion at para. 52-54 [Exhibit CWE-009].

⁴⁹⁵The FSC's vague warning that the approval process might take longer than usual was not sufficient notice under the Banking Act, because it did not notify HSBC of the reasons for not granting the approval within the 30-day prescribed time period. Banking Act, Art. 15(4) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 20,331 October 23, 2007), Art. 4-3 [Exhibit CA-096]; Park Expert Opinion at para. 62 [Exhibit CWE-015].

⁴⁹⁶ Park Expert Opinion at para. 62 [Exhibit CWE-015].

⁴⁹⁷ “Lone Star Submits Controlling Shareholder Qualification Related Materials,” FSS Press Release, September 9, 2008 [Exhibit C-082].

requested supplemental materials, there would still be no avoiding the fact that the actual reasons for delay were political and had nothing to do with the requirements of the Banking Act.⁴⁹⁸

258. In this case, the FSC well understood that its refusal to take action on HSBC's application would jeopardize the transaction. When the FSC failed to take action by April 30, 2008, the contract's original expiration date, it took a last-minute contract extension to keep the transaction alive. And even though the FSC had nearly derailed the deal in April, it soon became clear that the agency was prepared, over ardent objections from both parties, to allow the next expiration date to lapse without regulatory action. Even President Lee conceded the delay was wrongful, calling the failed HSBC acquisition a "lost opportunity" and criticizing the FSC for failing to take timely action.⁴⁹⁹ In Professor Park's view, the FSC's refusal to take action under these circumstances was tantamount to a denial of approval: "the FSC was clearly aware that the SPA executed by Lone Star and HSBC was to be terminated if HSBC's application for Excess Shareholding Approval was not granted by certain dates specified in those agreements."⁵⁰⁰

b. The FSC Improperly Failed to Make a Decision Based on HSBC's Qualifications and Instead Focused on Lone Star

259. As noted, in reviewing applications for bank acquisitions, the FSC is required to limit its review to the qualifications of the applicant. The Banking Act provides no basis to delay approval of an application based on concerns relating to the seller.⁵⁰¹ This is sensible because, as

⁴⁹⁸ Park Expert Opinion at para. 62 [Exhibit CWE-015]. Indeed, the FSC's failure to take action on HSBC's application went beyond procedural error. As Professor Park explains, although the violation of a processing period normally constitutes "procedural illegality," it can result in "substantive illegality" where the delay is "so serious that it can be seen as substantially equivalent to an action rejecting an application." Park Expert Opinion at para. 63 [Exhibit CWE-015].

⁴⁹⁹ "Be Puzzled by the Unexpected Statement of MB," *Kyunghang News*, September 22, 2008 [Exhibit C-248].

⁵⁰⁰ Park Expert Opinion at para. 63 [Exhibit CWE-015].

⁵⁰¹ Park Expert Opinion at paras. 53-54 [Exhibit CWE-015]; Baik Expert Opinion at paras. 52-53 [Exhibit CWE-009].

Professor Park explains, “the ‘legislative purpose’ of the excess shareholding limitation in the Banking Act is to prevent a major shareholder (or *chaebol*) from acquiring control over a bank and thereby threatening its soundness.”⁵⁰²

260. In this case, the FSC attributed the delays to “legal uncertainty” surrounding LSF-KEB’s involvement in alleged stock price manipulation in connection with the KEB Card merger.

261. But there were three problems with this excuse. First, it was wrong on the facts. The evidence is strong that this excuse was a pretext designed to obscure the fact that the regulators were basing their decisions on political rather than legal concerns. The FSC has shown itself to be highly sensitive to changes in the political environment. Its public position on the KEB acquisition seemed to change with the political fate of the administration. The FSC changed its position on the KEB acquisition a half dozen times during the nine-month period in which the HSBC transaction was pending, with most of the shifts prompted by political developments unrelated to the KEB acquisition (much less HSBC’s qualifications as a major shareholder).⁵⁰³ If there were any doubt that the FSC was guided by political rather than legal concerns, it was dispelled with the release of the Vershbow cable, which confirms through the candid admissions of the FSC’s top regulator what months of wavering and inaction could only suggest: The FSC refused to take action on HSBC’s application because it feared the political repercussions of approving a deal that would result in considerable profits for Lone Star.⁵⁰⁴

⁵⁰² Park Expert Opinion at para. 48 [Exhibit CWE-015]; Baik Expert Opinion at para. 30 [Exhibit CWE-009].

⁵⁰³ See Statement of Facts, Section III.K.

⁵⁰⁴ FSC Chairman on Lone Star, Bank Privatization and Financial Deregulation, Cable from U.S. Embassy in Seoul, July 25, 2008 [Exhibit C-426].

262. Second, even if taken at face value, the FSC's excuse was not a legitimate basis for delaying approval. The Banking Act provides no grounds for basing consideration on the conduct of the seller,⁵⁰⁵ and there is no exception to this rule where the seller is implicated in a criminal case.⁵⁰⁶

263. Finally, and as explained further below, even if the FSC were somehow permitted to take account of the seller's conduct, the particular conduct at issue could not have affected the pending transaction, because the most the FSC could do in response to a violation was require LSF-KEB to dispose of its shares.⁵⁰⁷

J. LONE STAR SELLS ITS KEB SHARES TO HANA FINANCIAL GROUP, BUT ONLY AFTER EXTENDED DELAY DUE TO THE REGULATORS' PARALYSIS AND ONLY AFTER THE REGULATORS FORCE A PRICE REDUCTION

264. After the global financial crisis and resulting recession subsided, in 2010, LSF-KEB attempted once again to sell its stake in KEB by launching a transparent worldwide search for buyers. Fortunately, the bank had been well managed during the crisis. Its capital position was now much improved and it was consistently producing strong earnings.⁵⁰⁸ As Mr. Klane notes, in 2010 KEB led Korean commercial banks in net interest margin, a key metric of profitability, while holding the lowest NPL loan ratio among Korean banks.⁵⁰⁹

265. Potential investors expressing tentative interest in the bank included the Australia and New Zealand Banking Group Limited and MBK Partners, a Korean private equity group, in

⁵⁰⁵ Park Expert Opinion at para. 48 [Exhibit CWE-015]; Baik Expert Opinion at paras. 32, 52-53 [Exhibit CWE-009].

⁵⁰⁶ Park Expert Opinion at para. 54 [Exhibit CWE-015]; Baik Expert Opinion at paras. 34, 58 [Exhibit CWE-009].

⁵⁰⁷ See Statement of Facts at paras. 276-277; Park Expert Opinion at paras. 39-41 [Exhibit CWE-015].

⁵⁰⁸ See Klane Witness Statement at para. 3 [Exhibit CWE-003].

⁵⁰⁹ See Klane Witness Statement at para. 23 [Exhibit CWE-003].

conjunction with Nomura Holdings.⁵¹⁰ But none of them was prepared to make an offer, daunted by the low probability of obtaining regulatory approval when the regulators had not even approved a strong, well-positioned bank like HSBC.⁵¹¹ This hesitation was surely reinforced by the fact that the FSC had resumed playing up to public opinion. News reports in June 2010 quoted a high-ranking official at the FSC declaring the regulators' determination to "stop foreign capital like Lone Star from purchasing the shares [of KEB]."⁵¹²

266. Nevertheless, Lone Star eventually found a potential purchaser in Hana, which was already the owner of another Korean bank, Hana Bank. As discussed in Section III.F.2 above, Hana had tried before to buy KEB but was beaten out by Kookmin Bank. In the absence of other purchasers, Hana was finally able to contract with LSF-KEB for its stake in KEB, but the FSC again delayed taking action on Hana's application for regulatory approval. During the last stage in the Lone Star saga, a final conviction in the KEB Card criminal proceedings led to an absurd situation in which the FSC ordered LSF-KEB to do what it had been trying for the past several years to do—sell its KEB shares—while, at the same time, the FSC refused to approve Hana's application to acquire the shares. Ultimately, the FSC would grant approval, but only after strong-arming LSF-KEB into agreeing to a reduced price that would placate the public's desire for Lone Star to be punished.

⁵¹⁰ See Thomson Witness Statement at para. 56 [Exhibit CWE-007].

⁵¹¹ See Thomson Witness Statement at para. 56 [Exhibit CWE-007].

⁵¹² "FSC-FSS Blame Each Other . . . While Lone Star Tries to Eat and Run," *Herald Business*, June 18, 2010 [Exhibit C-222].

1. November 2010: Hana Finally Succeeds in Bidding for KEB

a. LSF-KEB and Hana Enter into a SPA

267. LSF-KEB and Hana executed a SPA on November 25, 2010.⁵¹³ This SPA contemplated a sale price of approximately KRW 4.7 trillion and provided for a generous six-month term to close the sale.⁵¹⁴ As Mr. Short notes, these deals generally required only two to four months to close, including all regulatory approvals;⁵¹⁵ hence, six months should have been ample time for the sale to be consummated. The parties subsequently amended the SPA on December 9, 2010 to account for the issuance of a year-end dividend.⁵¹⁶

268. As explained below, in order for the sale to close, Hana had to obtain the approval of the FSC, and, on December 13, 2010, Hana submitted to the FSC its application to acquire KEB as a subsidiary.⁵¹⁷ Surprisingly, the FSC initially appeared receptive to Hana's application. According to an FSC spokesperson on December 15, 2010, the FSC would accelerate its review of Hana's application by foregoing the preliminary approval process and going straight to the actual approval process provided that (i) Hana had thoroughly prepared its application materials and (ii) the FSC found that the sale would not significantly impact the financial soundness of KEB and Hana.⁵¹⁸ Despite the FSC's initial confidence, however, it would be more than 13

⁵¹³ Share Purchase Agreement Between Lone Star and Hana Financial Group, November 25, 2010 [Exhibit C-227].

⁵¹⁴ See Share Purchase Agreement Between Lone Star and Hana Financial Group, November 25, 2010, Clauses 1.1, 9.1.2 [Exhibit C-227].

⁵¹⁵ See Short Witness Statement at para. 31 [Exhibit CWE-006]. See also Beard Expert Opinion at para. 5 [Exhibit CWE-010].

⁵¹⁶ See First Amendment to Share Purchase Agreement Between Lone Star and Hana Financial Group, December 9, 2010 [Exhibit C-229].

⁵¹⁷ See "Hana Financial Group Applies for Preliminary Approval for KEB Acquisition on December 13," *Newspim*, December 15, 2010 [Exhibit C-230].

⁵¹⁸ See "Hana Financial Group Applies for Preliminary Approval for KEB Acquisition on December 13," *Newspim*, December 15, 2010 [Exhibit C-230].

months before the FSC's approval was finally obtained, and many events harmful to LSF-KEB occurred in the meantime.

b. Hana Applies for Regulatory Approval under The Financial Holding Companies Act

269. Unlike HSBC, Hana was a financial holding company. Accordingly, Hana was applying to acquire a subsidiary pursuant to the FHCA, rather than under the Banking Act.⁵¹⁹ Unlike the Banking Act, which establishes specific time periods for processing certain applications,⁵²⁰ the FHCA does not specify its own time periods for processing applications. Instead, the relevant processing periods are codified in the Processing Standards for Civil Applications ("Processing Standards") adopted pursuant to the APA.⁵²¹ Under the Processing Standards, the FSC was required to issue a preliminary decision on Hana's application (which the FSC could choose to forego) within 60 days from receipt of the application and then its final, formal decision within 30 days.⁵²² These periods could be extended once by the same number of days at the regulator's discretion and could also be suspended if the FSC requested supplementary information.⁵²³

270. The primary purpose of the FHCA as stated in Article 1 is to secure the sound operation of financial holding companies and their subsidiaries by preventing the transfer of risks and excessive control that may arise as a result of a financial holding company growing into a

⁵¹⁹ See Park Expert Opinion at para. 72 [Exhibit CWE-015]; Baik Expert Opinion at paras. 67-68 [Exhibit CWE-009].

⁵²⁰ See Banking Act, Art. 15(4) [Exhibit C-048]; Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 20,331, October 23, 2007), Art. 4-3 [Exhibit CA-096].

⁵²¹ See Baik Expert Opinion at para. 74 [Exhibit CWE-009]; Park Expert Opinion at para. 79 [Exhibit CWE-015].

⁵²² See Baik Expert Opinion at para. 74 [Exhibit CWE-009]; Park Expert Opinion at para. 79 [Exhibit CWE-015].

⁵²³ See Baik Expert Opinion at paras. 74-75 [Exhibit CWE-009]; Park Expert Opinion at para. 56 [Exhibit CWE-015].

“mega-bank” and being able to engage in multiple banking and financial businesses.⁵²⁴ Thus, the criteria the FSC is supposed to apply in deciding whether to approve the application of a financial holding company that is seeking to acquire a subsidiary are not targeted at the seller of the bank but at ensuring the integrity of the bank and its acquirer, which in this case was Hana.⁵²⁵ For this reason, when considering Hana’s application, the FSC had no authority to consider attributes or issues relating to Lone Star, including the pending KEB Card proceedings.⁵²⁶ This, however, did not stop the FSC from doing so, as discussed below.

2. March 2011: On the Eve of FSC Approval, the Supreme Court Vacates Paul Yoo’s Acquittal, Giving the FSC Another Excuse for Delaying Action on Hana’s Application

271. By early February 2011, the FSC had signaled its intent to issue formal approval of Hana’s application by the end of March 2011—*i.e.*, within the time limits permitted by law.⁵²⁷ In the meantime, in typical fashion, the Korean media had voiced a variety of suspicions about the deal. Press reports questioned the apparent absence of a due diligence process and Hana’s ability to obtain sufficient funds to carry out the transaction.⁵²⁸ These reports speculated that Hana’s chairman Seung-yu Kim was relying on his personal relationship with Korean President

⁵²⁴ FHCA Art. 1 [Exhibit C-169].

⁵²⁵ See Park Expert Opinion at para. 75 [Exhibit CWE-015]; Baik Expert Opinion at para. 70 [Exhibit CWE-009].

⁵²⁶ See Park Expert Opinion at paras. 76-77 [Exhibit CWE-015]; Baik Expert Opinion at para. 79 [Exhibit CWE-009].

⁵²⁷ See “FSC Takes Final Steps to Complete KEB Sale,” *JoongAng Daily*, March 3, 2011 [Exhibit C-232].

⁵²⁸ See, e.g., “Second Financial Big Bang from Hana: Its Suspicious KEB Acquisition,” *KyungHyang Shinmun*, November 23, 2010 [Exhibit C-226].

Lee Myung-bak, a college friend, to pressure the regulators into approving the deal.⁵²⁹ The unions were also predictably opposed to the deal.⁵³⁰

272. However, the FSC seemed unfazed by the drumbeat of opposition, and on February 28, 2011, indicated that, at its regular committee session on March 16, it would review both (i) Hana's application to acquire KEB as its subsidiary and (ii) Lone Star's qualifications to be a major shareholder as a non-industrial conglomerate.⁵³¹ Although the FSC's formal language was non-committal, it signaled that the agency expected to approve Hana's application at that time.⁵³² Unlike in 2008 with HSBC, the FSC seemed determined to approve Hana's application, notwithstanding the ongoing KEB Card proceedings.⁵³³ Meanwhile, on March 10, 2011, the KFTC, the Korean antitrust authority, announced its approval of the sale.⁵³⁴

273. According to Mr. Ramstad, the change in the regulators' stance was due to two factors: First, by the time of the Hana deal, the general public and the government had developed "Lone Star fatigue," which opened the door for the government to approve the sale (although, as discussed below, the process was still difficult and the deal had to be renegotiated

⁵²⁹ See, e.g., "Second Financial Big Bang from Hana: Its Suspicious KEB Acquisition," *Kyunghyang Shinmun*, November 23, 2010 [Exhibit C-226].

⁵³⁰ See "Second Financial Big Bang from Hana: Its Suspicious KEB Acquisition," *Kyunghyang Shinmun*, November 23, 2010 [Exhibit C-226].

⁵³¹ See "Approval Expected on March 16 for Hana Financial Group Acquisition of KEB," *Yonhap News*, February 28, 2011 [Exhibit C-294].

⁵³² See, e.g., "Lone Star Qualifications and KEB Sale to Have Parallel Review," *Korea Economic Daily*, March 2, 2011 [Exhibit C-231]. See also Klane Witness Statement at para. 26 [Exhibit CWE-003]; Thomson Witness Statement at para. 58 [Exhibit CWE-007].

⁵³³ See Klane Witness Statement at para. 26 [Exhibit CWE-003]; Thomson Witness Statement at para. 58 [Exhibit CWE-007].

⁵³⁴ "Fair Trade Commission Determines Hana Financial Group's Acquisition of Korea Exchange Bank Lacks Anti-Competitive Effects," Fair Trade Commission Press Release, March 10, 2011 [Exhibit C-419].

on terms less favorable to Lone Star to make it palatable to the FSC and the public).⁵³⁵ Second, Koreans had regained confidence in the country's economic strength after Korea had recovered from the 2008-2009 global financial crisis faster than many other developed economies. As a result, the Korean public was better able to reconcile itself to the fact that foreign investors could leave after having profited from investing in the country.⁵³⁶ Some take the view that a third factor in the FSC's changed stance was the fact that KEB was being sold to another Korean bank, rather than to foreign capital.⁵³⁷

274. On February 28, 2011, the same date that the FSC indicated that it was going to consider (*i.e.*, approve) Hana's application to acquire KEB at its next scheduled meeting on March 16, the Supreme Court sent LSF-KEB a notice that on March 10, a week before the FSC's scheduled meeting, it would render its decision on the long-pending appeal of Paul Yoo's acquittal on stock manipulation charges in connection with KEB's rescue of KEB Card. At the time, no one made much of this notification. In hindsight, the timing of the notification perhaps should have been read to portend something more ominous – on that date, the Supreme Court vacated the Seoul High Court's acquittal of Mr. Yoo (and correspondingly the acquittals of KEB and LSF-KEB for vicarious liability), and remanded the case to the Seoul High Court for retrial.⁵³⁸ The decision took most observers by surprise given that the acquittal was perceived to be well-grounded, and the SPO's appeal had been pending since June 2008.⁵³⁹

⁵³⁵ See Ramstad Witness Statement at para. 9 [Exhibit CWE-005].

⁵³⁶ See Ramstad Witness Statement at para. 9 [Exhibit CWE-005].

⁵³⁷ See Overby Witness Statement at para. 13 [Exhibit CWE-004].

⁵³⁸ See Supreme Court Judgment, Case No. 2008Do6335, March 10, 2011 [Exhibit C-233].

⁵³⁹ The Seoul Prosecutors' Office filed the appeal of the acquittals on June 30, 2008. See Notice of Appeal by Seoul High Prosecutors' Office, June 30, 2008 [Exhibit C-194].

275. The Supreme Court's unexpected remand threw the FSC's approval process into disarray as the public uproar over the ruling and calls to punish Lone Star once again paralyzed the FSC. While the Supreme Court decision was legally and logically irrelevant to the FSC's consideration of Hana's application,⁵⁴⁰ the FSC nonetheless latched onto it as another reason to delay. Under Article 16-4(5) of the Banking Act, the FSC may order a shareholder that has been sanctioned within the preceding five years for violating a finance-related law or regulation (in this case, Articles 188-4(4)1 and 215 of the Securities and Exchange Act⁵⁴¹) to reduce its shareholding in a bank to 10% of the outstanding shares within a specified period of not more than six months.⁵⁴² Thus, if the courts ultimately determined that LSF-KEB had violated a finance-related law or regulation while it was a shareholder of KEB, then LSF-KEB would no longer be in compliance with the Banking Act's requirements for major shareholders, and the FSC would be authorized to order LSF-KEB to sell its shareholding in excess of 10% of KEB's shares. It was ostensibly on this basis that the FSC would delay acting on Hana's application.

276. However, whether or not Lone Star would lose its ability to hold more than 10% of the outstanding shares of KEB had absolutely nothing to do with Hana's application. Indeed, approving Hana's application would have meant that Lone Star would have disposed of its entire block of KEB shares, rendering a 10% restriction completely irrelevant.⁵⁴³ Furthermore, even if Lone Star or Paul Yoo were ultimately convicted, this would not give the FSC any additional authority to regulate the price or other terms of the sale. While the Banking Act gives the FSC

⁵⁴⁰ See Park Expert Opinion at paras. 76-78 [Exhibit CWE-015].

⁵⁴¹ See Securities and Exchange Act (Law No. 8.985, March 21, 2008) (repealed by Article 2 of the Addendum to the Financial Investment Services and Capital Markets Act, Law No., 8.635, on August 7, 2007 and effective as of February 4, 2009), Art. 188-4(4)1 and Art. 215 [Exhibit CA-095].

⁵⁴² See Banking Act (Law No. 11,051, amended by other laws and regulations on September 16, 2011), Art. 16-4(5) [Exhibit CA-117].

⁵⁴³ See Park Expert Opinion at paras. 83-87 [Exhibit CWE-015].

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the authority to order a sale, it does not give the FSC the authority to dictate the terms of the sale.⁵⁴⁴ The Act only authorizes the FSC to order the entity in question (LSF-KEB, in this case) to dispose of its shares,⁵⁴⁵ which is exactly what Lone Star was attempting to do. Therefore, there was no basis for the FSC to delay its consideration of Hana's application.⁵⁴⁶ Inexplicably, the FSC was using a law under which it could potentially, in the future, order Lone Star to sell its majority stake in KEB as an excuse for preventing Lone Star from selling that very same stake immediately.

277. The FSC's intentions became clear during the FSC's March 16 meeting, when it backtracked on its original indication that it would review Hana's application. Instead, the FSC merely re-affirmed that Lone Star was not an industrial conglomerate or NFBO, consistent with its determinations since Lone Star's initial acquisition of KEB in 2003.⁵⁴⁷ The FSC concluded at this meeting that, "considering the limitations of applying the Banking Act, the legislative intent of the NFBO policy, the issue of fairness with other foreign financial companies, and the fact that a share disposition order is an administrative action that severely disrupts private property interests, the FSC determined that regarding Lone Star Fund IV as an NFBO would be an unreasonable application of the Banking Act."⁵⁴⁸ It had taken the FSC nearly five years—since 2006—to reach this reassessment of Lone Star's status.

⁵⁴⁴ See Park Expert Opinion at paras. 88-91 [Exhibit CWE-015].

⁵⁴⁵ See Park Expert Opinion at paras. 84, 90 [Exhibit CWE-015].

⁵⁴⁶ See Park Expert Opinion at paras. 72-78 [Exhibit CWE-015].

⁵⁴⁷ See "Qualification Review Result for Shareholding in Excess of Prescribed Limit of Korea Exchange Bank," FSC Press Release, March 16, 2011 [Exhibit C-235].

⁵⁴⁸ "Qualification Review Result for Shareholding in Excess of Prescribed Limit of Korea Exchange Bank," FSC Press Release, March 16, 2011, at 4 [Exhibit C-235]. Even after reaching this conclusion, however, the FSS continued to send multiple requests for additional information on Lone Star's overseas affiliates that were irrelevant to its investment in KEB. See Letter from Lone Star Partners IV, L.P. to FSS, June 14, 2011, at 5 [Exhibit C-247].

278. On April 3, 2011, Mr. Grayken wrote to Chairman Seok-dong Kim of the FSC, informing him that Lone Star had heard from its counsel, Hana, and various press reports that the FSC had indefinitely postponed its consideration of Hana's application following the Supreme Court's decision to vacate Mr. Yoo's acquittal.⁵⁴⁹ In his letter, Mr. Grayken noted that, regardless of the final determination reached by the courts on the proceedings against Mr. Yoo, the only remedy available to the FSC would be to order LSF-KEB to sell its excess shareholding within six months – which was exactly what LSF-KEB had already contracted with Hana to do.⁵⁵⁰ Yet, the FSC was contradicting itself by preventing the sale from going forward, allegedly due to the possibility that the FSC *might* eventually be in position to order LSF-KEB to sell the shares.

279. Furthermore, in case the FSC was concerned that once LSF-KEB completed the sale it could immediately repatriate all of the sale proceeds to Belgium and exit the Korean market, thereby avoiding payment of any claims or penalties that might for whatever reason be brought against it later in Korea (notwithstanding that such concerns were beyond its purview), Mr. Grayken even offered to discuss precautionary measures that LSF-KEB could take to ensure that such payments would be made even after its departure.⁵⁵¹

280. Despite Mr. Grayken's overtures and repeated visits from Hana representatives to remind the FSC of Hana's potential losses from the delay in approving its application,⁵⁵² the FSC announced in a press briefing on May 12, 2011—six months after Hana's application—that, due to the pending court proceedings, it had suspended indefinitely a final determination on Lone

⁵⁴⁹ See Letter from John Grayken to FSC Chairman, April 3, 2011, at 1 [Exhibit C-237].

⁵⁵⁰ See Letter from John Grayken to FSC Chairman, April 3, 2011, at 2 [Exhibit C-237].

⁵⁵¹ See Letter from John Grayken to FSC Chairman, April 3, 2011, at 5 [Exhibit C-237].

⁵⁵² See Thomson Witness Statement at para. 61 [Exhibit CWE-007].

Star's qualifications as a major shareholder and, as a result of this suspension, would also postpone acting on Hana's application.⁵⁵³ The momentum of February and March 2011 had come to an abrupt end.

3. July 2011: The SPA Is Extended Until November 2011 in the Hope that Regulatory Approval Might Be Forthcoming

281. Reluctantly accepting the practical (if unlawful) reality that the sale would take more time to complete, but not willing to abandon the deal, Lone Star met with Hana in Tokyo in May 2011 to discuss steps that would solidify the parties' respective commitments to the SPA.⁵⁵⁴ The parties agreed that, in advance of the final sale, Hana would acquire 10% of KEB's shares—5% through Hana Bank and 5% through the holding company (*i.e.*, Hana Financial Group), at the same price per share as agreed for the whole block. This was the maximum amount of shares that Hana could acquire without requiring FSC approval.⁵⁵⁵ As part of the agreement, Hana also agreed to extend a loan facility of KRW 1.5 trillion to LSF-KEB, secured against its KEB shares. The parties memorialized these negotiated terms, first in a non-binding term sheet, and then, in a memorandum of understanding.⁵⁵⁶

282. Shortly after this agreement was reached, Hana called Lone Star with the surprising news that the FSC would not allow Hana to purchase the planned 10% of KEB's shares from Lone Star – despite the fact that the FSC had no legal authority to intervene in the

⁵⁵³ See, e.g., Financial Services Commission, Briefing on Korea Exchange Bank, May 12, 2011, at 1 [Exhibit C-241]. As was pointed out by a questioner during the briefing, the FSC's position contradicted its long-held position that the determination of Lone Star's qualifications as a major shareholder and the approval of Hana's application to acquire KEB as a subsidiary were separate legal issues. See *id.* at 3 [Exhibit C-241].

⁵⁵⁴ See Email from Byoung-ho Kim to Michael Thomson, May 25, 2011 (providing comments on the draft memorandum of understanding from the Tokyo negotiations) [Exhibit C-245].

⁵⁵⁵ See Short Witness Statement at para. 34 [Exhibit CWE-006].

⁵⁵⁶ See Thomson Witness Statement at para. 62 [Exhibit CWE-007].

transaction given that the amount of shares that Hana and Hana Bank had committed to purchase was lower than the minimum threshold triggering any need for FSC review.⁵⁵⁷ According to Mr. Short, who learned of this development from Mr. Byoung-ho Kim, a senior officer at Hana, although the government had no legal authority over these transactions, the FSC had pressured Hana not to proceed with either of the two 5% share purchases.⁵⁵⁸ As a result, Mr. Kim explained, Hana was forced to withdraw its interim share purchase proposal.⁵⁵⁹

283. The parties did proceed, however, with the loan agreement for KRW 1.5 trillion on July 1, 2011,⁵⁶⁰ but again the Korean government attempted to intervene without any legal authority to do so.⁵⁶¹ The BOK simply refused to accept the standard foreign exchange filing that LSF-KEB needed to make in order to remit the loan proceeds overseas.⁵⁶² As Mr. Thomson recounts, when Lone Star's attorneys at Kim & Chang sought to hand-deliver the filing, the BOK staff literally closed the filing window at the bank so that the filing could not be submitted.⁵⁶³ Consequently, Kim & Chang was forced to submit the required filing by mail, delaying the loan by several days. Lone Star and Hana were then able to move forward with the loan.⁵⁶⁴ This

⁵⁵⁷ See Short Witness Statement at para. 35 [Exhibit CWE-006].

⁵⁵⁸ See Short Witness Statement at para. 35 [Exhibit CWE-006].

⁵⁵⁹ See Short Witness Statement at para. 35 [Exhibit CWE-006].

⁵⁶⁰ Loan Agreement Between LSF-KEB Holdings SCA and Hana Bank, July 1, 2011 [Exhibit C-249]. The KRW 1.5 trillion consisted of a KRW 1.2 trillion term loan and a revolving loan facility of KRW 300 billion.

⁵⁶¹ See Short Witness Statement at para. 35 [Exhibit C-006]; Thomson Witness Statement at para. 63 [Exhibit C-007].

⁵⁶² See Thomson Witness Statement at para. 63 [Exhibit CWE-007].

⁵⁶³ See Thomson Witness Statement at para. 63 [Exhibit CWE-007].

⁵⁶⁴ See Thomson Witness Statement at para. 63 [Exhibit CWE-007].

incident indicated the extent to which Korean government officials sought to avoid being seen as assisting Lone Star in realizing its returns on its investment in KEB.⁵⁶⁵

284. As the parties continued to wait for the FSC to act on Hana's application to acquire Lone Star's KEB shares, the drop-dead date under the SPA came and went. On July 8, 2011, Lone Star and Hana agreed to extend the SPA until November 30, 2011, a full year from the SPA's original date of signature.⁵⁶⁶ The agreement adjusted the sales price, principally to account for a mid-year dividend.⁵⁶⁷

285. That same day, July 8, U.S. Senator Kay Bailey Hutchison and Congressman Jeb Hensarling both sent letters to the Korean Ambassador to the United States, Mr. Duck-soo Han, urging him on behalf of their respective constituents in Texas—including a number of Texas public employee pension funds—to make inquiries about the status of Lone Star's sale of its KEB shares and promote the resolution of the impasse with the FSC.⁵⁶⁸ In his response, Ambassador Han confirmed the FSC's position in its May press briefing that "it is difficult to specify a date of approval of the application by [Hana] for the acquisition of [KEB] while judicial proceedings are underway."⁵⁶⁹ Again, there was no recognition that the judicial proceedings relating to the alleged KEB Card stock price manipulation were wholly irrelevant to

⁵⁶⁵ See Thomson Witness Statement at para. 63 [Exhibit CWE-007].

⁵⁶⁶ Second Amendment to the Share Purchase Agreement, July 8, 2011, at Clauses 2, 12 (amending the termination of the SPA from 180 days after the execution of the SPA to November 30, 2011) [Exhibit C-250]; see also Hana Financial Group, Report to the FSC on Status of KEB Share Purchase Agreement, November 14, 2011, at 1 ("As the approval procedure on the acquisition of a subsidiary has been delayed longer than expected, both parties to the SPA executed an amendment to the SPA . . . on July 8, 2011.") [Exhibit C-271].

⁵⁶⁷ See Thomson Witness Statement at paras. 64, 73 [Exhibit CWE-007]; Second Amendment to the Share Purchase Agreement, July 8, 2011 [Exhibit C-250].

⁵⁶⁸ See Letter from Senator Kay Hutchison to Ambassador Duck-soo Han, July 8, 2011 [Exhibit C-251]; Letter from Congressman Jeb Hensarling to Ambassador Duck-soo Han, July 8, 2011 [Exhibit C-252].

⁵⁶⁹ Letter from Ambassador Duck-soo Han to Chairman Jeb Hensarling, July 15, 2011 [Exhibit C-253].

Hana's application and that, regardless of any court decision, the result would have been exactly the same – *i.e.*, Lone Star would sell its shares in KEB. According to Senator Gramm, President Lee faced similar pressure in person during a visit to Washington, D.C. to discuss the Korea-US Free Trade Agreement: “Leaders of both the House and the Senate raised concerns with President Lee directly that delays in approving the sale of KEB were adversely affecting police and fireman retirement funds and university endowments that had invested in the bank through Lone Star.”⁵⁷⁰ Senator Gramm believes that “these kinds of interventions registered with President Lee.”⁵⁷¹

4. October 2011: The FSC Orders LSF-KEB to Sell Its Shares But Still Does Not Approve Hana's Application

a. The FSC Strips LSF-KEB of Its Voting Rights and Orders Disposal of Its Shares

286. The final stage of the Lone Star saga was set when, on October 6, 2011, the Seoul High Court issued its final ruling in the KEB Card stock price manipulation case, convicting Paul Yoo (and, by vicarious liability, LSF-KEB) for wrongful conduct in connection with KEB's merger with KEB Card.⁵⁷² Although Lone Star's view was that the court's verdict was baseless, Lone Star nonetheless decided that it would be in its investors' best interests to allow the Seoul High Court decision to become final, rather than appeal the decision and risk further delay in the FSC's consideration of Hana's application. Lone Star would thereby provide the finality in the case that the FSC had declared repeatedly and publicly (but unlawfully) as being necessary before it would act on any application to acquire Lone Star's stake in KEB. Accordingly, LSF-

⁵⁷⁰ Gramm Witness Statement at para. 11 [Exhibit CWE-001].

⁵⁷¹ Gramm Witness Statement at para. 11 [Exhibit CWE- 001].

⁵⁷² See Seoul High Court Judgment, Case No. 2011No806, October 6, 2011 [Exhibit C-256].

KEB did not appeal the Seoul High Court's decision, and the ruling became final on October 13, 2011.⁵⁷³

287. In a series of letters to the FSC, Lone Star explained that LSF-KEB had decided not to appeal the decision and that, accordingly, LSF-KEB was no longer in a position to bring itself into compliance with the qualifications of a major shareholder under the Banking Act.⁵⁷⁴ Specifically, LSF-KEB could no longer satisfy the requirement that a major shareholder in a bank must not have been punished for violating finance-related laws and regulations.⁵⁷⁵ In effect, Lone Star was telling the FSC that it now had no choice but to approve the sale of LSF-KEB's shares.

288. Lone Star committed to pay within the prescribed period the fine of KRW 25 billion imposed by the Court and observed that the end of this lengthy litigation had removed the last of the FSC's stated obstacles to acting on Hana's application.⁵⁷⁶ Lone Star further emphasized that the sale agreement was at risk of being terminated at any time after the November 30, 2011 deadline expired.⁵⁷⁷ Moreover, Lone Star noted, the only appropriate remedy for the FSC at that point was to approve Hana's application, facilitating the removal of Lone Star as the major shareholder of KEB without needing to resort to the formalities of issuing

⁵⁷³ See Letter from John Grayken to FSC Chairman, October 12, 2011 [Exhibit C-257]. Mr. Paul Yoo chose to re-appeal his decision, but his re-appeal was finally dismissed by the Supreme Court on February 9, 2012.

⁵⁷⁴ See, e.g., Letter from John Grayken to FSC Chairman, October 12, 2011 [Exhibit C-257].

⁵⁷⁵ See Annex Table 1, Item 6, Sub-item (e) and Item 1, Sub-item (e) (2) of the Enforcement Decree to the Banking Act of Korea (Presidential Decree No. 22,577 December 30, 2010) [Exhibit CA-125].

⁵⁷⁶ See Letter from John Grayken to FSC Chairman, October 12, 2011 [Exhibit C-257].

⁵⁷⁷ See Letter from John Grayken to FSC Chairman, October 12, 2011 [Exhibit C-257].

a sale order. On these bases, Lone Star once again urged the FSC to approve the sale promptly.⁵⁷⁸

289. FSC Chairman Kim responded on October 17, 2011 in a brief fax, which stated simply that “[t]he FSC will deal with the application in accordance with relevant laws.”⁵⁷⁹ On the same day, the FSC notified Lone Star that it intended to issue a “Compliance Order” based on the finalized (as to Lone Star) Seoul High Court decision, which would order Lone Star to bring itself into compliance with the requirements of the Banking Act. As stated above, this was nonsensical on its face, since it was now impossible to “correct” Lone Star’s “noncompliance” based on a final and unappealable judgment convicting it (albeit vicariously) of a violation of a financial-related law. Recognizing that this was no more than a delay tactic by the FSC, Lone Star immediately responded to the FSC with a plea that the FSC focus instead on processing Hana’s pending application.⁵⁸⁰

290. Undeterred, the FSC issued the Compliance Order on October 25, 2011 (“Compliance Order”). This formal order prohibited LSF-KEB from exercising its voting rights in excess of 10% of KEB’s total issued and outstanding shares pending its compliance with the Compliance Order.⁵⁸¹ Notably, in its press release accompanying the Compliance Order, the FSC itself recognized that Lone Star could not possibly comply with the Compliance Order, stating that “[t]he three day grace period was granted because compliance with the foregoing

⁵⁷⁸ See Letter from John Grayken to FSC Chairman, October 12, 2011 [Exhibit C-257]; Letter from LSF-KEB to FSC, October 18, 2011 [Exhibit C-259]; Letter from LSF-KEB to FSC, October 25, 2011 [Exhibit C-260]; Letter from LSF-KEB to FSC, November, 1, 2011 [Exhibit C-266].

⁵⁷⁹ Letter from FSC Chairman to John Grayken, October 17, 2011 [Exhibit C-258].

⁵⁸⁰ See Letter from LSF-KEB to the FSC, October 18, 2011 [Exhibit C-259].

⁵⁸¹ Financial Services Commission, Compliance Order to Satisfy Major Shareholder Qualifications, October 25, 2011 [Exhibit C-261].

order was in fact not possible.”⁵⁸² Lone Star responded immediately to the Compliance Order, reiterating that it was impossible for LSF-KEB to satisfy the Compliance Order and requesting that the FSC take the necessary action to approve Hana’s application.⁵⁸³

291. In a second notice issued on October 31, 2011, the FSC informed Lone Star of its intent to issue another order – this one requiring Lone Star to divest its investment in KEB in excess of 10% of KEB’s total outstanding shares.⁵⁸⁴ The self-contradiction was breathtaking – the FSC was proposing to *order* LSF-KEB to sell its KEB shares, when LSF-KEB had been trying to do exactly that for five years, and the FSC had had sitting before it (for more than ten months) a request by a qualified buyer to be permitted to buy the shares. In its response to the notice, LSF-KEB reminded the FSC that its sale order would “be a mere formality, in that the Order is not necessary to cause LSF-KEB to dispose of its shares in KEB.”⁵⁸⁵ There was no need, Lone Star pointed out, to issue a sale order because, “as soon as [Hana’s] Application is approved, all of LSF-KEB’s shares in KEB would be transferred, whether or not the [sale] Order is issued.”⁵⁸⁶ Indeed, as Claimants’ legal expert Prof. Park notes, not only were the FSC’s actions completely unnecessary, they were in fact unlawful because LSF-KEB was in the process of disposing of its shares in KEB before the order was issued.⁵⁸⁷ None of these arguments convinced the FSC to withhold the sale order or prompted the FSC to act on Hana’s application.

⁵⁸² “FSS Report on the Qualification Review of KEB’s Major Shareholder and FSC Decision to Issue a Compliance Order,” FSC Press Release, October 25, 2011 [Exhibit C-283].

⁵⁸³ See Letter from LSF-KEB to FSC, October 25, 2011 [Exhibit C-260].

⁵⁸⁴ Financial Services Commission, Preliminary Notice of Contemplated Measure, October 31, 2011 [Exhibit C-265].

⁵⁸⁵ Letter from LSF-KEB to FSC, November 1, 2011 [Exhibit C-266].

⁵⁸⁶ Letter from LSF-KEB to FSC, November 1, 2011 [Exhibit C-266].

⁵⁸⁷ Park Expert Opinion at paras. 85-86 [Exhibit CWE-015].

b. The FSC Pushes Hana to Renegotiate the SPA and Submit a New Application with a Lowered Price

292. The purpose of the FSC's mystifying behavior soon became clear. The entire exercise with respect to the handling of Hana's application was nothing more than an attempt to force the parties to reduce the price, thereby enabling the FSC to demonstrate that it had extracted its pound of flesh from Lone Star before Lone Star left the country.

293. When the FSC issued its second notice on October 31, 2011 warning Lone Star that a sale order was imminent, Lone Star and Hana had only one month left before their already extended SPA was to expire on November 30, 2011. This drop-dead date was widely known and certainly known to the FSC. Lone Star soon learned that the FSC—responding to public and political pressure to sanction Lone Star and prevent it from reaping the profits that it stood to earn on the sale to Hana—was determined to withhold its approval until after the SPA expired.⁵⁸⁸ This would open the door for Hana to renegotiate the SPA at what the FSC anticipated would be a substantially lower price.⁵⁸⁹ In fact, the FSC would later make clear publicly that its approval of Hana's application would be contingent on a price reduction.⁵⁹⁰ In keeping with its deference to public sentiment, the FSC was responding to public pressure not to let Lone Star exit Korea with the full value of its investment.⁵⁹¹ In fact, a number of activist groups and politicians were

⁵⁸⁸ See Thomson Witness Statement at para. 70 [Exhibit CWE-007].

⁵⁸⁹ See Thomson Witness Statement at paras. 69-70 [Exhibit CWE-007].

⁵⁹⁰ See "FSC Orders Lone Star Share Disposal Within Six Months," FSC Press Release, November 18, 2011 [Exhibit C-274]; "FSC, Pressure on Hana Financial and Lone Star to Reduce Price," *Yonhap Infomax*, November 21, 2011 [Exhibit C-278]; "A Message to Hana Bank to Open a Safety Exit for Lone Star and to Lower the KEB Purchase Price," *Hankook Ilbo*, November 18, 2011 [Exhibit C-277].

⁵⁹¹ See, e.g., "Regulator Mulls Next Step on Lone Star's KEB Stakes Sale," *Yonhap News*, November 10, 2011 ("In what is deemed as a populist move ahead of next year's elections, politicians from both the ruling and opposition parties have also been drumming up support for punitive actions. 'It is not too late to issue a sale order after verifying whether Lone Star is a non-financial investor. [The gain of] a management premium should be prevented at the least,' Grand National Party chief Hong Joon-pyo said in a Twitter message, echoing Democratic Party leader Sohn Hak-kyu's earlier call for punitive action.") [Exhibit C-270].

even clamoring for the FSC to compel a sale of LSF-KEB's shares on the open market, which would have been financially destructive, flooding the market and driving down the share price.⁵⁹²

294. Over this period, Lone Star and Hana met a number of times to renegotiate and revise the SPA.⁵⁹³ Mr. Short also spoke frequently with his contact at Hana, Mr. Byoung-ho Kim, and reported on their conversations to Messrs. Grayken and Thomson. The essence of these conversations was that the FSC wanted Hana to renegotiate a new sale price that was sufficiently lower to give the FSC the political cover to appear that they had punished Lone Star and so could approve the deal. For example:

- October 28, 2011: "The FSC has asked Hana to approach us to renegotiate the price of our contract downward. The [FSC] realize they should approve the deal, but don[']t want to be criticized for allowing Lone Star to make too much profit.

I told him that the FS[C] should request this directly to us rather than going through Hana. He said that the FS[C] could not propose this to us since the request is improper because it is not within their scope to set the price. He said that is why they are doing it through Hana verbally rather than in writing.

He said that [C]hairman [K]im was told this directly by the FS[C].⁵⁹⁴

- October 29, 2011: "[Byoung-ho] reiterated that the FS[C] was pushing them to reduce the price. He said that Hana was happy that it was a good price and is anxious to close the deal as it is, and their request for a reduction is only because of the FS[C] demands."⁵⁹⁵
- November 1, 2011: "[Byoung-ho] repeated what he said last time: that the FSC was pressuring them to renegotiate a lower price to 'give them an excuse' to approve the deal. I, of course, told him that the sale order should be excuse enough."⁵⁹⁶

⁵⁹² See, e.g., "Opposition Party and Civic Groups Urge Punitive Disposal Order," *Asia Economic Daily*, November 7, 2011 [Exhibit C-269].

⁵⁹³ See Transcript of Meeting Between Lone Star and Byoung-ho Kim, November 2011 [Exhibit C-268]; Transcript of Meeting Between Lone Star and Hana Representatives, November 25, 2011 [Exhibit C-228]; Short Witness Statement at para. 40 [Exhibit CWE-006].

⁵⁹⁴ Email from Ellis Short to Michael Thomson and John Grayken, October 28, 2011 [Exhibit C-263].

⁵⁹⁵ Email from Ellis Short to John Grayken and Michael Thomson, October 29, 2011 [Exhibit C-264].

295. In a separate letter to Mr. Grayken, Chairman Kim of Hana also insisted that the parties would have to enter into a new contract and, in doing so, “should find a way to alleviate political pressure on FSC in approving the transaction, especially by reflecting market valuation and turbulent financial industry.”⁵⁹⁷ In a draft response that Mr. Grayken contemplated sending to Hana Chairman Kim, Mr. Grayken acknowledged hearing from Hana that the FSC was putting pressure on it to “renegotiate [the] agreement to reduce the price, in order to appease certain nationalistic and political elements in Korea,” but declined to agree to a price reduction because “it would be entirely inappropriate, indeed unlawful, for the Korean government to interfere in the commercial aspects” of the sale.⁵⁹⁸

296. At the regulator’s request, Hana then submitted to FSC Chairman Seok-dong Kim a report on the status of its SPA with LSF-KEB.⁵⁹⁹ In this report, Hana informed the FSC that it was pursuing renegotiation of the terms—and particularly the price—of the contract, reporting that: “Lone Star has been notified that, in view of the political climate in Korea, the changes to the legal status of Lone Star after the execution of the SPA Amendment and the recent changes to the environment of the financial markets, there is a need to change some of the terms and conditions of the SPA (including the proposal to reduce the existing purchase price), and HFG is promoting discussions thereon.”

⁵⁹⁶ Email from Ellis Short to John Grayken and Michael Thomson, November 1, 2011 [Exhibit C-267].

⁵⁹⁷ Email from Hana Chairman to John Grayken, October 28, 2011 [Exhibit C-262].

⁵⁹⁸ Email Chain Regarding Letter from Chairman Kim, November 3, 2011 [Exhibit C-311]. The draft response was not sent. In an earlier email in the chain, Mr. Thomson similarly stated that a number of advisors to Lone Star had counseled that “SD (FSC) Kim [*i.e.*, FSC Chairman Kim] wants to move forward with the sale to HFG, but feels he can’t do so without some price reduction to take the heat off of them.” *Id.* at 3 [Exhibit C-311].

⁵⁹⁹ Hana Financial Group, Report to FSC on Status of KEB Share Purchase Agreement, November 14, 2011 [Exhibit C-271].

297. Four days after Hana's report, on November 18, 2011, the FSC held a special session to approve the promised disposition order that required Lone Star to dispose of its KEB shares within six months, by May 18, 2012 ("Disposition Order").⁶⁰⁰ As a result of the Disposition Order, Lone Star was caught between a rock and a hard place: (i) it was facing an order from the Korean government to dispose of the vast majority of its shares within a short period of time; but (ii) the Korean government would not issue the requisite approval enabling Lone Star to sell those shares to Hana, as Lone Star had been trying to do for the past year and was still under a committed contract to do.

298. Importantly, in its November 18, 2011 press release discussing the Disposition Order, the FSC affirmed what Lone Star had been arguing all along: that there was no basis, in law or in logic, for the FSC to have delayed approving the potential buyers' applications when the result of any litigation or investigation would, at most, simply have been for LSF-KEB to sell its shares in KEB. The FSC acknowledged that, despite demands from a number of anti-foreign activist groups and politicians, it could not lawfully issue a so-called "punitive disposition order" against Lone Star that would attach certain conditions to the divestment of its KEB shares that would have the effect of punishing Lone Star financially.⁶⁰¹ According to the FSC, it was permitted only to order that the shares be sold, and this was the case regardless of whether

⁶⁰⁰ See Financial Services Commission, Notice of Measures Against Shareholder of KEB, November 18, 2011 [Exhibit C-276]; "FSC Orders Lone Star Share Disposal Within Six Months," FSC Press Release, November 18, 2011 [Exhibit C-274]. The six month term was applied based on a similar order issued by the FSC in one other case and the record number of shares held by LSF-KEB. As noted in a media report, even if LSF-KEB had sold its shares on the open market at the rate of 1.4 million shares per day (the daily average trading amount in the previous three months), it would still have taken LSF-KEB more than 180 days to dispose of its approximately 265 million excess shares. *See id.* at 3.

⁶⁰¹ "FSC Orders Lone Star Share Disposal Within Six Months," FSC Press Release, November 18, 2011, at 13 [Exhibit C-274]. *See also* Park Expert Opinion at paras. 89-91 (noting that there is no basis in the Banking Act for an interpretation that the regulator may attach conditions to a share disposal order because the legislative intent of the statute of promoting the safety and soundness of the banking system is fulfilled simply by depriving a major shareholder of its major shareholder status) [Exhibit CWE-015].

(i) Lone Star lost its eligibility to be a major shareholder in KEB due to the fact that it was held vicariously liable for stock manipulation, or (ii) Lone Star lost its status as a non-industrial conglomerate.⁶⁰²

299. The FSC similarly acknowledged that there was no reason for it to delay approval until it reached a “final” determination on Lone Star’s NFBO status when Lone Star had been fully prepared to divest its shares. The FSC admitted that, even after it had reached its initial determination in 2003 that Lone Star was not an industrial conglomerate, the FSC had thereafter—in response to allegations by “some media outlets and politicians”—reopened an investigation⁶⁰³ on the status of Lone Star’s overseas affiliates.⁶⁰⁴ This was despite having already concluded that, based on Article 16-4(5) of the Banking Act,⁶⁰⁵ even if Lone Star were later found to be an industrial conglomerate, the FSC could only issue a mandatory sale order and could not impose additional conditions such as a sale on the open market.⁶⁰⁶ Thus, there had been no purpose for the reassessment of Lone Star’s non-industrial conglomerate status that the FSC had carried out for over five years other than to satisfy the public calls for such a reevaluation.

⁶⁰² “FSC Orders Lone Star Share Disposal Within Six Months,” FSC Press Release, November 18, 2011, at 10-14 [Exhibit C-274].

⁶⁰³ See, e.g., Financial Supervisory Service, Request for Submission of Materials, June 7, 2011 (attaching a KBS News story questioning the FSC’s determination that Lone Star Fund IV was not an NFBO, based on its ownership of approximately 3.7 trillion won worth of golf courses in Japan) [Exhibit C-246].

⁶⁰⁴ “FSC Orders Lone Star Share Disposal Within Six Months,” FSC Press Release, November 18, 2011, at 5 [Exhibit C-274].

⁶⁰⁵ Banking Act, Art. 16-4(5) (Law No. 11,051, amended by other laws and regulations on September 16, 2011) [Exhibit CA-117].

⁶⁰⁶ See “FSC Orders Lone Star Share Disposal Within Six Months,” FSC Press Release, November 18, 2011, at Exhibit 3 [Exhibit C-274].

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300. Having concluded that it could not lawfully attach conditions to the sale of LSF-KEB's shares, the FSC then appears to have decided to do exactly that, but indirectly, using Hana as a willing conduit for obtaining a price reduction that would have the same effect of "punishing" Lone Star. Thus, in addition to ordering LSF-KEB to dispose of its excess shareholding, the FSC also signaled in its press release that it was expecting a new application from Hana, announcing that:

A significant time has lapsed since the submission of the application by the Hana Financial Group, and there has been a significant change to the factual background relating to the requirements for the addition of KEB

Lone Star has lost its major shareholder status due to the guilty verdict on the share price manipulation case, which limits Lone Star's voting rights with respect to those shares held in excess of the prescribed limit (i.e., 41.02% out of 51.02% held by Lone Star) as of October 25, 2011.

Considering the changes taking place to the circumstances, it is viewed that it is difficult to proceed with the approval process based on the previously submitted application for the addition of subsidiary.

*Accordingly, the FSC has resolved to notify the Hana Financial Group to submit a fresh application concerning the addition of subsidiary, taking into account the changes to the circumstances.*⁶⁰⁷

301. Thus, according to the FSC, meaningful "changes to the circumstances" had occurred since Hana had submitted its original application almost a year earlier that could affect Hana's takeover of KEB, and, therefore, Hana would have to submit a new application taking these changes into account.⁶⁰⁸ Remarkably, however, the changed circumstances that the FSC

⁶⁰⁷ "FSC Orders Lone Star Share Disposal Within Six Months," FSC Press Release, November 18, 2011, at 6-7 (emphasis added) [Exhibit C-274].

⁶⁰⁸ "FSC Orders Lone Star Share Disposal Within Six Months," FSC Press Release, November 18, 2011, at 7 [Exhibit C-274].

highlighted were, in fact, changes that the *FSC* had itself caused to take place – for example, the fact that Lone Star had been stripped of its voting rights in excess of 10% of KEB’s shares. More importantly, those changes of circumstances had absolutely nothing to do with Hana’s qualifications to acquire KEB and, therefore, nothing to do with how the FSC should have assessed Hana’s application.

302. What the FSC really meant, however, was that it could not approve the acquisition until the price was reduced. Indeed, public comments by FSC officials surrounding this press release made it even clearer to Lone Star that the FSC expected Hana to demand a lower price for its acquisition of Lone Star’s shares in KEB and submit a new application for approval.⁶⁰⁹ One FSC commissioner stated, for example, that “once a new application is submitted . . . the financial soundness of HFG will be reviewed and *the price will also be a factor*.”⁶¹⁰ Another FSC official noted that the FSC would “wait and see, as Hana Financial Group said that they would lower the price.”⁶¹¹ The FSC was therefore conditioning its approval based on its assessment of the privately negotiated commercial terms of the deal, which, again, was wholly irrelevant to an assessment of Hana’s qualifications to acquire the bank and wholly outside the legal discretion of the FSC.

303. The Korean press were in wide agreement that the FSC was seeking to pressure Hana to negotiate a lower price. Yonhap News, for instance, observed that “[t]he FSC placed pressure[] on HFG and Lone Star by demanding HFG resubmit the application for approval to

⁶⁰⁹ See “FSC, Pressure on Hana Financial and Lone Star to Reduce Price,” *Yonhap Infomax*, November 21, 2011 [Exhibit C-278].

⁶¹⁰ “FSC, Pressure on Hana Financial and Lone Star to Reduce Price,” *Yonhap Infomax*, November 21, 2011 (emphasis added) [Exhibit C-278].

⁶¹¹ “A Message to Hana Bank to Open a Safety Exit for Lone Star and to Lower the KEB Purchase Price,” *Hankook Ilbo*, November 18, 2011 [Exhibit C-277].

acquire KEB at the same time as issuing the compulsory sale order.”⁶¹² The Hankook Ilbo also reported that the FSC’s recommendation that Hana submit a new application “can be interpreted as a message to ‘lower the purchase price.’”⁶¹³ It quoted a high-ranking FSC official as stating the FSC’s view to be that “KEB’s share price has fallen considerably, so the current contract price is excessive.”⁶¹⁴ This was a particularly ironic justification for lowering the sale price given that KEB’s share price was depressed precisely because of the prolonged contract with Hana.⁶¹⁵

304. Armed with the Disposition Order and the FSC’s clear mandate, Hana on November 18, 2011 announced that it would commence price negotiations with Lone Star.⁶¹⁶ Hana insisted that Lone Star agree to a substantial price reduction, asserting that a price cut was necessary for the FSC to approve Hana’s application without further delay. Facing the deadline of the Disposition Order, with no realistic prospect of starting yet another sales process to find a different buyer within such a limited amount of time, and unwilling to simply dump all of its shares on the open market at a severely depressed price, Lone Star had little choice but to accede to Hana’s demands to cut the sale price.

305. Transcripts of two conversations between (i) Mr. Ellis Short and his Hana contact Mr. Byoungcho Kim, and (ii) Mr. John Grayken and Chairman Kim of Hana on November 25,

⁶¹² “FSC, Pressure on Hana Financial and Lone Star to Reduce Price,” *Yonhap Infomax*, November 21, 2011 [Exhibit C-278].

⁶¹³ See “A Message to Hana Bank to Open a Safety Exit for Lone Star and to Lower the KEB Purchase Price,” *Hankook Ilbo*, November 18, 2011 [Exhibit C-277].

⁶¹⁴ “A Message to Hana Bank to Open a Safety Exit for Lone Star and to Lower the KEB Purchase Price,” *Hankook Ilbo*, November 18, 2011 [Exhibit C-277].

⁶¹⁵ See, e.g., Transcript of Meeting Between Lone Star and Hana Representatives, November 25, 2011 [Exhibit C-228].

⁶¹⁶ “A Message to Hana Bank to Open a Safety Exit for Lone Star and to Lower the KEB Purchase Price,” *Hankook Ilbo*, November 18, 2011 [Exhibit C-277].

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OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37

2011, further evidence the pressure that the FSC was placing on Lone Star using Hana as a willing conduit. As the excerpts below show, the FSC was fully aware that its demands for a lower price were unlawful and was careful, therefore, to use Hana as its proxy:

- Ellis: And the regulator wants us to take a lower price because they feel like that makes the people happy?

Byoung-ho: [N]ot that way, but opposite way for them to protect themselves. . . . [Chairman Kim persuaded them to] give the approval – twice. And I think that was persuaded. But with a condition, which is the justification; justification that the regulators should have to protect themselves at least.⁶¹⁷

- Byoung-ho: They will find other excuses if they think that . . . you know, if really, the price is the heart of the matters, then I think not the price [but] other excuses for them to have to delay the approval process. I am sure about that because that's what they did twice in March. So

Ellis: And what's important? The headline number, the price per share – that's what's important?

Byoung-ho: Yeah. So the rationale that we can think of with this number is, not 70% premium, but 50% premium over current market price.⁶¹⁸

- Ellis: Because what they're doing is illegal. And they don't mind if you know they're doing, they're conducting illegal activity. They don't want us to know.

Byoung-ho: That is, that is why there is no proof that they are asking price reduction. . . . They are very careful. They really do not want to be, uh, so that's the difficulty that we have.⁶¹⁹

- Chairman Kim: They told me, we should reduce at least 20% of the, you know, our contracted price, which is under 11,000 won per share. So I can't do that, no way. They would not accept this proposal at all. I tried to push it, and, and they still told me under 11,000 won per share Well, if you insist under 11,000 won share, I can try to push it and 11,900. That's the only way, you know, I can contact with Lone Star people . . . I told them.

Mr. Grayken: So they specifically told you the price they wanted you . . .

⁶¹⁷ Transcript of Meeting Between Lone Star and Byoung-ho Kim, November 2011 [Exhibit C-268].

⁶¹⁸ Transcript of Meeting Between Lone Star and Byoung-ho Kim, November 2011 [Exhibit C-268].

⁶¹⁹ Transcript of Meeting Between Lone Star and Byoung-ho Kim, November 2011 [Exhibit C-268].

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

Chairman Kim: Not FSS. It will not accept FSS. Well, I met many congressmen, many national . . .

Mr. Grayken: National senators, you're talking about?

Chairman Kim: Yeah. . . .

Mr. Grayken: Okay. Let me, let me ask you this, a simple question, which is, you're asking us for something. You're saying to change the contract. Reduce the price by 500 billion won. And so I have to ask you a simple question, which is: if we do that, what assurances can you give me that the FSC is going to approve this deal? Why should we, why should we do this without something in return?

Chairman Kim: Well, if we decide the price, I'll give you assurance within one or two days.

Mr. Grayken: So you have, have you discussed this price reduction with the FSC?

Chairman Kim: Not really, but uh, I do have a feeling. I do have many dialogues with FSC. But I have a feeling, I told them one trillion won reduction. I told them, "He's kidding. No way." I talked to, you know, FSC people. One trillion reduction, no way.

Mr. Grayken: Have they asked you to reduce it?

Chairman Kim: No. They didn't say anything. But . . . they told me, I should, you know, recognize political part- two parties', you know, reaction on this deal.

Mr. Grayken: They said that?

Chairman Kim: Yeah.

Mr. Grayken: They said that their, that this is important to them?

Chairman Kim: That's why two parties, you know, all these Chairman of the FSS should step down.

Mr. Grayken: And both of those parties want the price reduced today? So the FSC has basically told you that they need the, they need the price reduced as well?

Chairman Kim: That's right. . . .

Mr. Grayken: But they didn't say how much?

Chairman Kim: Many, many, you know, National Assemblymen, rather than . . .

Mr. Grayken: So you can't tell us then, if we, if we, uh, agree to a price reduction . . .

Chairman Kim: Well...

Mr. Grayken: . . . that they will be approved?

Chairman Kim: Well, I can assure you within tomorrow because FS Ch- FS Chairman is coming to London tomorrow night. But he's on the way back to Seoul. He just stop over London.

Mr. Grayken: Okay.

Chairman Kim: I supposed to meet him on the airport⁶²⁰

306. Backed into a corner, on December 3, 2011, Lone Star agreed to reduce the sale price from KRW 13,390 per share to KRW 11,900 per share, reducing the total sale price to approximately KRW 3.9 trillion from the initial approximately KRW 4.7 trillion.⁶²¹ On the face of the SPA, this was an approximately \$500 million reduction in projected proceeds from the sale.⁶²²

c. The FSC Continues Its Campaign Against Lone Star But Finally Approves Hana's Application

307. Coinciding with the continued pressure on Lone Star to lower the sale price, on November 24-25, 2011, the FSS also conducted a special examination of KEB, after which it issued on November 28 two notices of Contemplated Measures of Examination Results against (i) KEB and (ii) KEB's Lone Star-appointed directors. According to the FSS, its examination led it to conclude that the Lone Star-appointed directors should face "heavy discipline," which at its most severe could be a recommendation for dismissal from office.⁶²³

⁶²⁰ Transcript of Meeting Between Lone Star and Hana Representatives, November 25, 2011 [Exhibit C-228].

⁶²¹ Amended and Restated Share Purchase Agreement Between Lone Star and Hana Financial Group, December 3, 2011, Clause 1.1 [Exhibit C-280]; Thomson Witness Statement at para. 73 [Exhibit C-007].

⁶²² See Thomson Witness Statement at para. 73 [Exhibit C-007].

⁶²³ See Financial Supervisory Service, Prior Notice of Contemplated Measures of Examination Results, November 28, 2011 [Exhibit C-279].

308. Mr. Klane also recalls being pressured by the FSC to remove Messrs. Thomson and Short from the KEB Board (as well as Mr. Yoo, who by then was in detention).⁶²⁴ The FSC issued a notice of sanction recommending their dismissal from the KEB Board and then took the extraordinary measure of directing KEB to call a shareholders' meeting to vote on their dismissal.⁶²⁵ The FSC also urged the bank to block these directors from board deliberations until that meeting took place.⁶²⁶ Although Mr. Klane had previously explained that, as the CEO, he had no authority to remove these directors from the KEB Board,⁶²⁷ this did not stop the FSC from issuing on December 28, 2011 a formal "recommendation" that he evict the directors.⁶²⁸

309. With only two days left until the SPA with Hana expired (for the second time), rather than working to approve Hana's application, the FSC was choosing instead to spend its time and energy on pushing KEB's management to "fire" the Lone Star-appointed directors from its Board.⁶²⁹ As Mr. Short observes, these exertions were completely misguided, for two reasons: First, KEB's management had no power to remove directors from its Board, as this was the exclusive purview of KEB's shareholders.⁶³⁰ Second, once the FSC approved the sale to Hana, the parties would be able to close on the sale, at which point the directors in question

⁶²⁴ See Klane Witness Statement at para. 31 [Exhibit CWE-003].

⁶²⁵ See Klane Witness Statement at para. 31 [Exhibit CWE-003]. See also Thomson Witness Statement at para. 32 [Exhibit CWE-007].

⁶²⁶ See Klane Witness Statement at para. 31 [Exhibit CWE-003].

⁶²⁷ See Klane Witness Statement at para. 18 [Exhibit CWE-003].

⁶²⁸ See Financial Supervisory Service, Notice of Instruction Regarding Operation of Board of Directors, December 28, 2011 [Exhibit C-284].

⁶²⁹ See Short Witness Statement at para. 37 [Exhibit CWE-006].

⁶³⁰ See Short Witness Statement at para. 37 [Exhibit CWE-006]. See also Klane Witness Statement at para. 18 [Exhibit CWE-003].

would resign immediately pursuant to the SPA.⁶³¹ Thus, the FSS was demanding a measure that was at the same time impossible and unnecessary. The only explanation for this bizarre behavior seems to be that it was thought to increase the pressure on Lone Star to agree to the lowered sale price demanded by the regulators.⁶³²

310. After Lone Star had acceded to the new price terms and amended SPA, Hana filed a second application with the FSC on December 5, 2011.⁶³³ Because of the hostile political climate surrounding the sale, however, the FSC continued to delay action on even this re-filed application. On January 17, 2012, almost two weeks past the initial 30-day statutory period for acting on Hana's second application, Lone Star wrote yet again to the FSC, noting the impossible situation in which it had been placed by the FSC's Compliance Order and Disposition Order absent approval of the Hana acquisition.⁶³⁴ Should the FSC continue to fail to act on Hana's application, Lone Star stated, it would be compelled to pursue claims under the Belgium-Luxembourg-Korea BIT.⁶³⁵

311. The FSC finally approved Hana's purchase of Lone Star's shares on January 27, 2012.⁶³⁶ In its press release covering the approval, the FSC acknowledged that (i) until the final conviction on October 13, 2011, Lone Star had continually satisfied the qualifications for a major

⁶³¹ See Short Witness Statement at para. 37 [Exhibit CWE-006]. See also Declaration and Opinion for the Sanction Review Committee, December 15, 2011, at 3 (“[A]s the Directors will voluntarily resign after carrying out their duties to transfer KEB's management, any such sanctions would have no practical effect.”) [Exhibit C-281].

⁶³² See Thomson Witness Statement at paras. 66-73 [Exhibit C-007].

⁶³³ See Thomson Witness Statement at para. 74 [Exhibit C-007].

⁶³⁴ See Letter from John Grayken to FSC Chairman, January 17, 2012 [Exhibit C-287].

⁶³⁵ See Letter from John Grayken to FSC Chairman, January 17, 2012 [Exhibit C-287].

⁶³⁶ See “Qualification Review Results for KEB's Major Shareholder,” FSC Press Release, January 27, 2012 [Exhibit C-290]; “South Korea Gives Hana Green Light on KEB Stake,” *Wall Street Journal*, January 27, 2012 [Exhibit C-291].

shareholder;⁶³⁷ (ii) there were no grounds to deem Lone Star an industrial conglomerate (NFBO) at the time of its acquisition of KEB; and (iii) there was no basis for such a finding even after the extended 2006-2011 reevaluation conducted by the FSC.⁶³⁸

d. After Hana's Application Is Approved, Further FSC-Imposed
Conditions on the Closing Come to Light

312. Once the FSC had officially approved Hana's application on January 27, 2012, the parties began preparing to close the sale. The FSC's interference in the parties' private transaction, however, had not yet come to an end.

313. While negotiating the reduced-price SPA in November 2011, Lone Star and Hana had agreed that, if the sale did not close by December 31, LSF-KEB would be entitled to its respective share of any year-end 2011 dividend that might be issued in 2012, even after the sale closed, because such dividends are paid to the shareholders of record as of the end of the fiscal year.⁶³⁹ As the sale did not close by December 31, Lone Star stood to benefit from any FY 2011 dividend declared at the 2012 Annual Shareholders' Meeting ("AGM") to be held in March 2012.⁶⁴⁰ LSF-KEB was entitled to attend that AGM and vote its shares, up to the 10% limit imposed by the FSC, in favor of any such dividend.⁶⁴¹

⁶³⁷ See "Qualification Review Results for KEB's Major Shareholder," FSC Press Release, January 27, 2012, at 1-2 [Exhibit C-290].

⁶³⁸ See "Qualification Review Results for KEB's Major Shareholder," FSC Press Release, January 27, 2012, at 4-5 [Exhibit C-290]. In addition, the FSC acknowledged that the majority of the legal commentators it had consulted had advised that a share disposal order could not have been based on this reevaluation of Lone Star's non-NFBO status because "an administrative order must be based on the factual background and laws in effect at such time." *Id.* at 5 [Exhibit C-290].

⁶³⁹ See, e.g., Transcript of Meeting Between Lone Star and Hana Representatives, November 25, 2011 [Exhibit C-228]; Klane Witness Statement at para. 33 [Exhibit CWE-003].

⁶⁴⁰ Klane Witness Statement at para. 33 [Exhibit CWE-003].

⁶⁴¹ Thomson Witness Statement at para. 77 [Exhibit CWE-007].

314. To that end, on February 6, 2012, LSF-KEB sent a letter to KEB requesting to add to the agenda for the upcoming AGM the issuance of a FY 2011 dividend of KRW 500/share.⁶⁴² The KEB Secretariat, without KEB CEO Mr. Klane's approval, immediately transmitted the proposed agenda item to Hana.⁶⁴³ Hana quickly made clear to Lone Star that it opposed any such dividend. Mr. Byoung-ho Kim explained to Mr. Short that, in response to the regulators' demands, Hana had committed to the FSC that Lone Star would not receive any additional consideration in relation to its KEB shares other than the sale price agreed in the revised SPA.⁶⁴⁴ Accordingly, Mr. Kim stated that Hana would not proceed with the closing unless LSF-KEB agreed not to pursue, or support in any way, a FY 2011 dividend.⁶⁴⁵

315. The FSC's position as explained by Hana was clearly outside the scope of its regulatory authority, but just as Lone Star saw up close in connection with KEB's forced rescue of KEB Card, the FSC had the ability to exert enormous pressure upon its regulated institutions, making Hana's account a credible one. This was yet another loss for LSF-KEB, but like the loss from the price reduction in the renegotiated SPA, LSF-KEB simply was in no position to object, particularly with the deadline on the Disposition Order looming. As a result, LSF-KEB retreated and withdrew its request to KEB to include the dividend on the agenda for the AGM, further agreeing that it would not attend the AGM and also would not in any way support any FY 2011 dividend.⁶⁴⁶

⁶⁴² See Shareholder Proposal from LSF-KEB to KEB, February 6, 2012 [Exhibit C-292].

⁶⁴³ Klane Witness Statement at para. 35 [Exhibit CWE-003]; Thomson Witness Statement at para. 78 [Exhibit CWE-007].

⁶⁴⁴ See Email from Ellis Short to Michael Thomson and John Grayken [Exhibit C-293].

⁶⁴⁵ See Email from Ellis Short to Michael Thomson and John Grayken [Exhibit C-293].

⁶⁴⁶ Thomson Witness Statement at para. 79 [Exhibit CWE-007].

316. With that issue cleared away, the sale of LSF-KEB's shares in KEB to Hana was able to close on February 9, 2012 at the substantially discounted price that Hana had extracted from LSF-KEB on December 3, 2011 (and with no FY 2011 dividend).⁶⁴⁷ After six years of repeated attempts, Lone Star was finally able to sell its stake in KEB and permanently exit the Korean market.

K. HARASSMENT OF LONE STAR PERSISTS EVEN AFTER IT EXITS KOREA

317. Even after finally selling its stake in KEB, Lone Star's travails in Korea remained far from over and continue even today. For example, Lone Star has continued to be harassed by frivolous lawsuits filed by various anti-foreign activist groups seeking to reverse the FSC's final 2011 determination that Lone Star was not an industrial conglomerate, apparently seeking to undo Lone Star's 2003 acquisition of KEB and everything that followed, including Lone Star's sale to Hana. Recently, the Korean courts refused to enforce an award favorable to Lone Star in an ICC arbitration between a Lone Star affiliate and the Korea Deposit Insurance Corporation. In addition, as discussed in Section III.L.4.c below, the NTS continues to insist upon unreasonable and inconsistent taxes on the proceeds of the sale of KEB that the NTS ordered Hana to withhold from the closing amount.

1. Activist Groups File Additional Lawsuits Against Lone Star

318. From the onset of the anti-foreign investor fervor that swept the country beginning in 2005 and continuing today, Lone Star was harassed by civil lawsuits filed in connection with its investment in KEB and the bank's merger with KEB Card. These lawsuits, most of which were dismissed for being duplicative or lacking legal basis, were filed by many of

⁶⁴⁷ See Report on Transfer of Securities in the OTC Market, February 10, 2012 [Exhibit C-423].

the same groups and individuals that prompted the investigations in 2006 – in particular, Hwa-Sik Jang and Spec Watch.

319. Similarly, the same members of the National Assembly who spearheaded the legislators' audits of Lone Star, such as National Assemblyman Ki-joon Kim, also filed an appeal to the Constitutional Court on July 6, 2012 to request a reversal of the FSC's determinations with respect to Lone Star's status as a non-industrial conglomerate.⁶⁴⁸

320. Also in July 2012, civic organizations led by People's Solidarity for Participatory Democracy filed a shareholders' derivative lawsuit with the Seoul Central District Court against LSF-KEB and former directors thereof demanding the return of dividend income and profits that Lone Star obtained as KEB's controlling shareholder.

321. All told, thirteen frivolous and politically motivated lawsuits have been initiated against Lone Star, and many of them continue despite the fact that Lone Star is no longer a shareholder in KEB.

2. The Korean Courts Refuse to Enforce an ICC Arbitral Award Issued in Lone Star's Favor

322. Most recently, a Korean appellate court has refused enforcement of an international arbitration award obtained by a joint venture company in which Lone Star was invested against a Korean government-owned asset resolution corporation. The award for approximately US \$35 million was obtained in 2011 by LSF-KDIC Investment Company, Ltd.

⁶⁴⁸ See How to Respond to Lone Star's Provocative Act of Filing ISD Claim, National Assembly Discussion Paper, October 24, 2012, at 21 [Exhibit C-296].

against Korea's Resolution and Finance Corporation, now known as Korea Resolution & Collection, in connection with the return of a shareholder distribution.⁶⁴⁹

323. The Korean courts have refused to enforce the award, first citing "public policy" and, most recently on August 16, 2013, claiming that there was never an agreement to arbitrate the dispute in the first instance. First, the Seoul Central District Court in September 2012 cited public policy as a ground for refusal, saying that the award effectively endorsed actions by the claimant that were contrary to a Korean statute governing asset-backed securitization. That argument had been expressly argued to and rejected by the ICC tribunal, was refuted by the claimant before the District Court, and subsequently did not persuade the Seoul High Court on appeal.

324. Instead, the Seoul High Court, on August 16, 2013, relied on an entirely different ground for refusing enforcement. The Seoul High Court pointed to a lack of an arbitration agreement – despite a clear and detailed finding by the ICC tribunal in the award that its jurisdiction was well founded, based on an arbitration clause in a contract to which claimant and respondent were both parties, and which was sufficiently broad in scope to encompass the dispute. The applicability of the arbitration agreement was not substantially argued before the Seoul High Court on appeal. The Seoul High Court did not acknowledge in its ruling that it was revisiting—and directly contradicting—the ICC tribunal's analysis on the jurisdictional issue.

325. The Korean courts' refusal to honor the ICC award in Lone Star's favor and against a Korean government-sponsored enterprise represents yet another example of the harassment to which Lone Star was and continues to be subjected in Korea.

⁶⁴⁹ "Seoul Court Rejects Lone Star Enforcement," *Global Arbitration Review*, September 6, 2013 [Exhibit C-301].

L. ARBITRARY ENFORCEMENT BY THE KOREAN TAX AUTHORITIES IN RESPONSE TO POLITICAL OPPOSITION TO LONE STAR

326. The FSC was not the only Korean government agency that manifestly abused its authority in response to the Korean public's growing hostility toward foreign investment in general, and toward Lone Star in particular. The Korean National Tax Service ("NTS") also targeted Lone Star's investments, effectively penalizing Lone Star by assessing nearly \$1 billion in taxes without justification. However, the methods employed by the two Korean government agencies were polar opposites. Whereas the FSC reacted to the public backlash against foreign investment with indecision and evasive inaction, the NTS responded with a single-minded determination to tax the gains from Lone Star's (including Claimants') investments regardless of the legality, consistency, or fairness of its actions. The NTS repeatedly imposed illegitimate tax liabilities with respect to Claimants' investments in violation of the Korea-Belgium Tax Treaty⁶⁵⁰ and Korean law.

327. The NTS's mission was clear. Lone Star's investments in Korean companies such as KEB were directly owned by six of the Claimants—Belgian entities that were entitled to the protection of the Tax Treaty between Belgium and Korea.⁶⁵¹ Under this Tax Treaty, the gains on these investments would be exempt from Korean tax and the dividends would be subject to a lower tax rate in Korea (which Claimants timely and properly paid). That outcome was simply not acceptable. The public demanded that Lone Star not be permitted, under any circumstance, to exit Korea with the full value of its investments. And so the NTS went to

⁶⁵⁰ Convention between the Republic of Korea and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Brussels on August 29, 1977 ("Korea-Belgium Tax Treaty") [Exhibit CA-264].

⁶⁵¹ The Claimants are six Belgian investment holding companies that purchased, held, and sold the investments in issue. Because Claimant Star Holdings SCA was liquidated, its claims are being brought by the two co-owners of its unallocated assets, Claimant Lone Star Capital Management SPRL and Claimant Lone Star Capital Investments S.à.r.l.

extraordinary lengths to use taxation as a means to keep as much of Lone Star's money in Korea as possible. The assessment of taxes on the capital gains and dividends that Claimants earned on their Korean investments, despite clear treaty obligations to the contrary, quickly became a highly politicized issue that implicated the highest levels of the Korean government.⁶⁵² Finding some way—any way—to levy massive taxes became a political mantra and a matter of national pride. Foreigners, many Koreans believed, were seeking to plunder Korea of its wealth, and the NTS could not stand by and let that happen.

328. The tax assessments discussed below involve dividends from, and gains from the sale of the shares in, four Korean companies, each owned by Belgian affiliates of Lone Star using essentially identical structures. This Section begins with a discussion of the toxic environment in which the income and gains from these four companies were realized and the public and political forces at work that caused the NTS to target these investments with baseless tax assessments. Next is a brief summary of the tax concepts applicable to these Korean investments. We then provide a brief summary of each of the four NTS assessments⁶⁵³ that form the basis of Claimants' claims for arbitrary, abusive, and unlawful taxation. This is followed by a detailed discussion of how the NTS's tax assessments were fundamentally erroneous, arbitrary, and inconsistent, most notably because the NTS refused to respect Claimants as the substantive owners of the investment income in order to deny them the benefits under the Korea-Belgium

⁶⁵² See, e.g., "The Ruling Party, 'We Will Certainly Tax Lone Star,'" *Maeil Business Newspaper*, April 5, 2006 [Exhibit C-115]; "Deputy Prime Minister Says 'Capital Gains Tax Can Be Imposed on Lone Star,'" *Financial News*, April 12, 2006 ("Acting Prime Minister and Minister of Finance and Economy Han Duck-soo Wednesday remarked, 'The government believes that it can impose tax on Lone Star's capital gains from the sale of Korea Exchange Bank (KEB)'" [Exhibit C-118]; "Submission of proposal for amendment to the tax law to step up taxation on foreign funds ... by withholding taxes on tax-evading companies," *Dong-A Ilbo*, April 26, 2006 ("Withholding taxes on tax-evading companies," *Dong-A Ilbo*) (quoting National Assembly Member Ooh Che-chang as saying, "We have no intention of hiding that the bill is targeting Lone Star.") [Exhibit C-122].

⁶⁵³ These include the corresponding local surtax assessments, which follow automatically.

Tax Treaty to which they were entitled, and because the NTS then had to further resort to a range of unsupported and inconsistent theories to achieve its goal of punitive taxation. The final part of this Section provides a chronology of the NTS's ever-changing positions, highlighting the inconsistencies and demonstrating the arbitrary and capricious manner in which the NTS has sought to inflict maximum taxation. This Section as a whole makes clear that the NTS's targeted tax assessments for these four transactions were unlawful, inconsistent, discriminatory, and arbitrary.

329. In addition to this discussion, included with this Memorial are two expert reports that explain in greater detail these many NTS violations. Dr. Luc De Broe, an expert in Belgian and international taxation and tax treaties, elaborates on how the NTS's conduct violates the plain language of the Korea-Belgium Tax Treaty and contradicts universally recognized principles of international taxation.⁶⁵⁴ Professor Chang Hee Lee, an expert in Korean tax law, elaborates on how the NTS's tax assessments and imposition of withholding tax are inconsistent with Korea's own tax laws, judicial precedent, and practice in other similar cases.⁶⁵⁵ These more detailed and comprehensive examinations of the NTS's abusive conduct toward Claimants' interests in Korea conclusively demonstrate that the NTS manifestly abused its authority under both domestic and international tax law.

330. Even without delving too deeply into the nuances of tax law in this Section, however, it is clear that the NTS's conduct with respect to Claimants was—and continues to be—capricious, internally contradictory, and legally baseless. Whether individually or taken as a

⁶⁵⁴ See generally Expert Opinion of Dr. Luc De Broe, October 11, 2013 (“De Broe Expert Opinion”) [Exhibit CWE-011].

⁶⁵⁵ See generally Lee Expert Opinion [Exhibit CWE-012].

whole, the NTS's course of conduct amounts to a politically driven campaign to inflict the maximum financial "punishment" on Lone Star's interests in Korea and Claimants' investments in particular.

1. Korea's Politically-Motivated Campaign to Impose Arbitrary and Abusive Taxes on Lone Star and Other Foreign Private Equity Funds

331. The arbitrary NTS tax assessments discussed below took place in the wake of the political backlash against foreign investment in Korea, and against Lone Star in particular, that was described in Sections III.E and III.F above. The Korean public's sentiment toward foreign investment in the financial sector soured rapidly beginning in 2004.⁶⁵⁶ Resentment toward foreign investment then escalated when, from March 2004 through April 2005, three foreign private equity funds (Lone Star, Carlyle, and Newbridge) sold significant Korean investments (STC, KorAm Bank, and Korea First Bank, respectively), realizing substantial profits and claiming the benefits of applicable tax treaties.⁶⁵⁷ For example, on January 18, 2005, Spec Watch Korea, the anti-foreign investment civic group described in Section III.E.4 above, held a widely publicized news conference in front of the NTS building in Seoul, during which it threatened: "If the government does not impose taxes on those speculative forces, we will take legal action against them."⁶⁵⁸ The negative coverage of these transactions in the Korean press inflamed nationalistic views that such investors were engaging in "eat and run" investments that were "pillaging" Korea's resources.

⁶⁵⁶ See Anti-Foreign Capital Sentiment Rages," *Korea Times*, August 24, 2004 (noting that hostility toward foreign investment in the banking sector was particularly high) [Exhibit C-071].

⁶⁵⁷ See Short Witness Statement at para. 20 [Exhibit CWE-006].

⁶⁵⁸ "Civic Group Calls for Taxation of 'Foreign Hedge Funds'," *Yonhap Daily News*, January 18, 2005 [Exhibit C-346].

332. The public's outrage at foreign investors and pleas for Lone Star to be punished did not fall on deaf ears. Korean political forces soon insisted that Lone Star's investments be taxed, even if it meant enacting targeted or retroactive laws. The political determination to impose Korean taxes on Lone Star and other private equity funds was always about placating (or taking advantage of) the hostility of the Korean public toward those foreign investors. It was never about faithfully administering Korea's tax laws.

333. The fundamental obstacle the politicians and regulators faced in their effort to tax Lone Star was that many of Lone Star's investments in Korea were owned by Lone Star entities in Belgium. This meant that the proceeds of the sales of those investments were protected by the Korea-Belgium Tax Treaty and either would not be subject to tax in Korea or would be subjected to a lower Korean tax rate than would otherwise be the case. Consequently, the government spent years trying to find ways to circumvent Respondent's obligations under the Tax Treaty and extract the maximum amount of taxes from Lone Star, regardless of the legality or justification for such measures. To this end, they sought to avoid the application of the Tax Treaty by: (i) dismissing Belgium as a tax haven, (ii) treating Claimants as mere paper companies and fronts for the "true" investors that in some cases Respondent never even went to the trouble to identify, (iii) disregarding corporate formalities and decades of practice, and (iv) applying wildly inconsistent and mutually exclusive theories to identical factual situations.

334. The first steps Respondent took to avoid the application of its tax treaties began in early 2005 when, according to media reports, the Economic Advisory Council of Korea's Blue House submitted a report titled "Influence of Inflows of Speculative Foreign Funds and

Suggested Countermeasures” and reported it to President Roh Moo-Hyun.⁶⁵⁹ The Council reportedly concluded that “it is possible to levy taxes” on foreign investors by resorting to a domestic tax law concept, the substance-over-form principle, that could be stretched to override tax treaty undertakings and deny benefits that the text of those treaties expressly confer on foreign investors in Korea.⁶⁶⁰

335. The National Assembly also pressured the NTS to scrutinize foreign private equity funds. In March 2005, NTS Deputy Commissioner Ju-Sung Lee appeared before the National Assembly to assure lawmakers that the NTS would “closely inspect whether” Lone Star and other foreign private equity funds “were abusing the tax exemption policies.”⁶⁶¹

336. The NTS reacted to the intense public pressure and growing anti-foreign investment sentiment within the Roh government and National Assembly by setting in motion a series of aggressive tax audits and tax assessments designed to forcibly extract the maximum amount of tax from Lone Star.⁶⁶² As noted in Section III.E.2 above, in April 2005, the NTS launched an unlawful raid on the Seoul offices of Lone Star-affiliated service companies LSAK and HAK.⁶⁶³ The NTS had not obtained a warrant to search the premises, and LSAK and HAK

⁶⁵⁹ See “The Blue House Began Reviewing Measures For Dealing With Speculative Capitals Early This Year,” *Donga Ilbo*, April 15, 2005, at 1 [Exhibit C-078].

⁶⁶⁰ “The Blue House Began Reviewing Measures For Dealing With Speculative Capitals Early This Year,” *Donga Ilbo*, April 15, 2005, at 2 [Exhibit C-078].

⁶⁶¹ See “NTS Explains on Its Homepage the Reasons, Timing of the ‘Tax Audit into Foreign Funds,’” *Money Today*, April 22, 2005 [Exhibit C-083]; see also “Seoul Tax Inquiry on Foreign Funds,” *New York Times*, April 15, 2005 [Exhibit C-080].

⁶⁶² See “The Blue House Began Reviewing Measures For Dealing With Speculative Capitals Early This Year,” *Donga Ilbo*, April 15, 2005, at 1 [Exhibit C-078].

⁶⁶³ See Thomson Witness Statement at para. 25 [Exhibit CWE-007]; see also “Seoul Tax Inquiry on Foreign Funds,” *New York Times*, April 15, 2005 [Exhibit C-080]; “Foreign Funds’ Frowns,” *Korea Times*, April 25, 2005 (describing the repeated visits and “blitzkrieg style” of the tax probes) [Exhibit C-087].

refused to consent to the raid.⁶⁶⁴ Nevertheless, the chief executive of HAK negotiated an agreement with the NTS whereby the NTS could examine any records that were pertinent to the NTS's tax audit.⁶⁶⁵ The NTS agreed, but then proceeded to forcibly seize whatever records it could find, including those that were highly confidential, proprietary, irrelevant to the tax audit, and cordoned off in separate areas of the offices under lock and key.⁶⁶⁶ The NTS conducted these raids with force, without warrants, and without consent. As Professor Chang Hee Lee describes, these raids were "clearly illegal and an abuse of the NTS's authority."⁶⁶⁷

337. After illegally raiding the LSAK and HAK offices, the NTS concluded its tax audit by assessing massive new taxes on a number of Lone Star investments and business interests in Korea. That outcome was apparently a foregone conclusion: in an interview with the news media in December 2005, NTS Commissioner Ju-sung Lee expressed his view that his agency's failure to "get" the foreign investment funds "would have been tantamount to Korea's defeat in a power game with the overseas hedge funds."⁶⁶⁸ The article notes that the NTS defied the skeptics when it "slapped five of the funds with [KRW] 214.8 billion (US \$214.8 million) in punitive taxes and reported staff in [*sic*] Lone Star's Korean branch to prosecutors for tax evasion."⁶⁶⁹

338. From 2005-2006, the Korean government took two further actions designed to curb perceived abuses of tax treaties by foreign investment firms. First, Korea sought to

⁶⁶⁴ See Thomson Witness Statement at para. 25 [Exhibit CWE-007].

⁶⁶⁵ See Thomson Witness Statement at para. 26 [CWE-007].

⁶⁶⁶ See Thomson Witness Statement at para. 27 [CWE-007].

⁶⁶⁷ Lee Expert Opinion at para. 139 [Exhibit CWE-012].

⁶⁶⁸ "Tax Chief Recalls Battle with Foreign Hedge Funds," *The Chosun Ilbo*, December 9, 2005 [Exhibit C-418].

⁶⁶⁹ "Tax Chief Recalls Battle with Foreign Hedge Funds," *The Chosun Ilbo*, December 9, 2005 [Exhibit C-418].

renegotiate its tax treaties, including the Tax Treaty with Belgium, to allow the NTS to tax capital gains where the foreign investor owned more than 25% of the shares in a Korean company.⁶⁷⁰ Second, in December 2005, the National Assembly adopted a law amending the tax code to impose a special withholding regime on payments from Korea to companies located in any “tax haven,” with MOFE designating which countries would be labeled as tax havens.⁶⁷¹ Belgium was one of the countries considered for inclusion on the list of designated tax havens.⁶⁷² Contemporaneous observers linked the consideration of Belgium as a potential tax haven to the ongoing campaign against Lone Star.⁶⁷³ In the end, Korea neither amended its Tax Treaty with Belgium to qualify the full tax exemption for capital gains⁶⁷⁴ nor designated Belgium as a tax haven, but the NTS nevertheless proceeded to act in disregard of the Tax Treaty and treated Belgium as if it were a tax haven.

⁶⁷⁰ See “Taxing Lone Star Still Uncertain,” *Korea Times*, May 3, 2006 (“[The Ministry of Finance and Economy] has also begun multiple negotiations with countries that Korea has formed bilateral tax treaties with to allow the Korean government to impose taxes on capital gains realized by foreign investors here if the investor owns a 25 percent or more stake in a Korean firm.”) [Exhibit C-347].

⁶⁷¹ See Bill to Partially Amend the Corporate Tax Act, Bill No. 4298, April 21, 2006 (describing the bill adopted in December 2005 to institute a special withholding regime) [Exhibit CA-262]; see also “Five Foreign Funds Taxed W215 bln for Irregularities,” *Yonhap News*, September 29, 2005, at 1-2 (“In a bid to curb the abuse of tax codes by foreign investors, South Korea is seeking to revise related tax laws. According to a draft of revised tax codes, the country’s tax authorities would levy withholding taxes on foreign funds registered in tax havens if their South Korean operations transfer investment gains to them.”) [Exhibit C-348].

⁶⁷² “Lone Star Set to Wage Battle over S. Korean Taxation,” *Asia Pulse*, March 24, 2006 (“The Finance Ministry is moving to revise tax treaty-related laws, thus designating Belgium as a tax haven.”) [Exhibit C-349]; “S. Korean Watchdog to Pressure Lone Star to Pay Taxes on Profits,” *Asia Pulse*, March 27, 2006 (“The Finance Ministry is moving to revise tax treaty-related laws, thus designating Belgium as a tax haven, but the bill is now pending at the National Assembly.”) [Exhibit C-350].

⁶⁷³ “Lone Star Set to Wage Battle over S. Korean Taxation,” *Asia Pulse*, March 24, 2006 (“South Korea’s tax authorities have shown strong willingness to impose taxes on the [Lone Star’s] profit from its sale of the stake in KEB.”) [Exhibit C-349].

⁶⁷⁴ Notably, in 2010, Korea and Belgium *did* amend the treaty. But that amendment did not include any changes to Article 13, which provides the full exemption from taxation of capital gains on shares in companies and other movable property. Instead, the amendment related to Article 25, which deals with the exchange of information between regulators. See De Broe Expert Opinion at para. 6 [Exhibit CWE-011]. As Dr. Luc De Broe explains, this and other formal amendments to the language of the Korea-Belgium Tax Treaty “are an illustration of Belgium’s consistent policy with respect to tax treaties, consisting in negotiating formal amendments to its tax treaties when amendments appear necessary to address changing circumstances or to put an end to applications of the treaty considered as abusive by the Belgian authorities.” *Id.*

339. By February and March 2006, media reports were speculating that the Korean government might designate Belgium a “tax haven” under the new law instituting the special withholding tax,⁶⁷⁵ and if so, that determination “would force Lone Star to pay about 600 billion won in taxes from the sale” of KEB.⁶⁷⁶ Later that same month, the Korean media reported that the NTS was “reviewing various ways to levy taxes on Lone Star”⁶⁷⁷ and that the NTS would “do whatever it takes . . . to levy taxes on [the] profits taken by Lone Star.”⁶⁷⁸ To prove it, the NTS publicly boasted about the methods it was contemplating using to target Lone Star and circumvent the Korea-Belgium Tax Treaty, including (i) ignoring Claimants that legally owned assets in Korea in order to tax affiliated entities in countries that did not offer the same protections as Belgium,⁶⁷⁹ and (ii) amassing “evidence” that Lone Star conducted its business through a fixed place in Korea so that the NTS could tax Lone Star’s income as “business profits” attributable to a “permanent establishment”⁶⁸⁰ in Korea (which would make the income taxable under Korea’s tax treaties), rather than as the passive foreign investment income that it was.⁶⁸¹

⁶⁷⁵ “Time Running Out for Lone Star,” *The Chosun Ilbo*, February 21, 2006 [Exhibit C-351].

⁶⁷⁶ “Lone Star Set to Wage Battle over S. Korean Taxation,” *Asia Pulse*, March 24, 2006 [Exhibit C-349]. On March 15, 2006, Ministry of Finance and Economy gave a preliminary indication that it would *not* designate Belgium a tax haven under the new law. See “Good News for Lone Star: Belgium No Tax Haven,” *The Chosun Ilbo*, March 15, 2006 [Exhibit C-352].

⁶⁷⁷ “National Tax Service Might Collect One Trillion Won in Taxes from Lone Star,” *Financial News*, March 26, 2006 [Exhibit C-353].

⁶⁷⁸ “S. Korean Watchdog to Pressure Lone Star to Pay Taxes on Profits,” *Asia Pulse*, March 27, 2006 [Exhibit C-350].

⁶⁷⁹ “The Ruling Party, ‘We Will Certainly Tax Lone Star,’” *Maeil Business Newspaper*, April 5, 2006 [Exhibit C-115].

⁶⁸⁰ The concept of a “permanent establishment” or “PE” is discussed further in sub-section 2(c) below.

⁶⁸¹ “National Tax Service Might Collect One Trillion Won in Taxes from Lone Star,” *Financial News*, March 26, 2006 [Exhibit C-353]. Indeed, anonymous NTS officials were quoted as saying, “We believe that Lone Star did its business (regarding KEB) through its Korean unit, which must have followed its directions. We also have secured enough evidence to prove it.” “S. Korean Watchdog to Pressure Lone Star to Pay Taxes on Profits,” *Asia Pulse*, March 27, 2006 [Exhibit C-350].

340. By April 2006, taxing Lone Star had become more than simply a populist notion; it had become a matter of political expediency. The Mael Business Newspaper reported on April 5, 2006 that “[t]he ruling party is supporting the tax authorities in taxing Lone Star.”⁶⁸² In that article, several unnamed ruling party officials were quoted as speculating on various theories that could be used to overcome the barriers to taxing Lone Star in Korea. For example, one ruling party official was quoted as saying:

Some have said that if Lone Star Korea is viewed as a permanent place of business of the Lone Star fund, it would be subject to taxation. However, this seems difficult because the requirements for a permanent place of business are very strict. Instead, we are currently focusing on investigating the evidence obtained that supports the actual beneficiary of the profit from investment of Lone Star fund is a Luxemburg entity . . . The National Tax Service (NTS) had recently reported their findings to the ruling party’s leadership and conveyed the message that it was confident that taxes could be imposed on Lone Star.⁶⁸³

341. After this briefing from the NTS, the leadership of the ruling party agreed to back the NTS’s effort to impose such taxes on Lone Star and other foreign private equity funds by any means possible.⁶⁸⁴ One lawmaker on the Finance and Economy Committee of the National Assembly that explained some of the “various methods” being considered including renegotiating the Korea-Belgium Tax Treaty and new measures with respect to withholding

⁶⁸² “The Ruling Party, ‘We Will Certainly Tax Lone Star’,” *Mael Business Newspaper*, April 5, 2006 [Exhibit C-115].

⁶⁸³ “The Ruling Party, ‘We Will Certainly Tax Lone Star’,” *Mael Business Newspaper*, April 5, 2006 [Exhibit C-115].

⁶⁸⁴ “The Ruling Party, ‘We Will Certainly Tax Lone Star’,” *Mael Business Newspaper*, April 5, 2006 [Exhibit C-115].

tax.⁶⁸⁵ But in a telling admission, that lawmaker acknowledged that “[t]he tax issue of Lone Star does not depend on the factual grounds *but rather on political choice and will*.”⁶⁸⁶

342. The reason why there was so much focus on how to support the NTS’s efforts to tax Lone Star was transparent, as reported in that news article:

The main reason why the leaders of the ruling party are taking such a strong stance is because (i) they believe the taxes should be imposed on such large amount of profits and (ii) in front of May 31 local elections, they want to avoid the negative public opinion that may arise from their failure to impose the taxes on Lone Star’s capital gains of more than KRW 4 trillion from the sale of KEB.

Another contributing factor is the concern that taking a lukewarm approach to taxing Lone Star could potentially even adversely affect the [chances of the] ruling party’s candidates for next year’s presidential election.⁶⁸⁷

343. Indeed, the issue became so politically charged that, when Deputy Prime Minister Duck-soo Han reportedly cast doubt on the feasibility of lawfully taxing Lone Star,⁶⁸⁸ a core party official was quoted as saying:

The leaders of the ruling party will sack Mr. Han, the Minister of Finance and Economy, if they believe such dismissal is required to impose the taxes on Lone Star, and the ruling party supported the NTS in the power game between the MOFE and the NTS with respect to the taxation on Lone Star.⁶⁸⁹

⁶⁸⁵ “The Ruling Party, ‘We Will Certainly Tax Lone Star,’” *Maeil Business Newspaper*, April 5, 2006 [Exhibit C-115].

⁶⁸⁶ “The Ruling Party, ‘We Will Certainly Tax Lone Star,’” *Maeil Business Newspaper*, April 5, 2006 (emphasis added) [Exhibit C-115].

⁶⁸⁷ “The Ruling Party, ‘We Will Certainly Tax Lone Star,’” *Maeil Business Newspaper*, April 5, 2006 [Exhibit C-115].

⁶⁸⁸ “The Ruling Party, ‘We Will Certainly Tax Lone Star,’” *Maeil Business Newspaper*, April 5, 2006 (quoting Mr. Duck-Soo Han, the Minister of Finance and Economy as stating, “For the time being, it is difficult to predict whether we can tax Lone Star.”) [Exhibit C-115].

⁶⁸⁹ “The Ruling Party, ‘We Will Certainly Tax Lone Star,’” *Maeil Business Newspaper*, April 5, 2006 [Exhibit C-115].

344. Just a week after this threat, Deputy Prime Minister Han publicly announced that “[t]he government sees that the tax authorities can impose tax on Lone Star’s capital gains from the sale of Korea Exchange Bank.”⁶⁹⁰

345. The National Assembly’s plan to target Lone Star for taxation indirectly by having the MOFE designate Claimants’ State of residence, Belgium, a “tax haven”⁶⁹¹ however, encountered difficulties. Unlike some of the other private equity funds operating in Korea at the time, which had injected capital into their investments via tax havens such as Labuan, Malaysia,⁶⁹² Lone Star’s Korean investments were owned and managed by companies based in Belgium. MOFE officials had made several public statements dampening expectations that it would designate Belgium a tax haven.⁶⁹³ As observed in contemporaneous media reports:

Under this law, withholding taxes on Lone Star's capital gains from the sale of Korea Exchange Bank will be difficult in practical terms, as it would be impossible to name Belgium, where Lone Star is headquartered, as a tax haven.⁶⁹⁴

346. But the prospect of Lone Star exiting Korea without being taxed on its investment returns was unacceptable. So, on April 21, 2006, Che-chang Ooh, a lawmaker from the governing Uri Party, and twelve other legislators submitted to the National Assembly a proposed revision to the tax code that would have granted MOFE the extraordinary authority⁶⁹⁵ to

⁶⁹⁰ “Deputy Prime Minister Says ‘Capital Gains Tax Can Be Imposed on Lone Star,’” *Financial News*, April 12, 2006 [Exhibit C-118].

⁶⁹¹ “Withholding taxes on tax-evading companies,” *Dong-A Ilbo*, April 26, 2006 [Exhibit C-122].

⁶⁹² These include the investments that NewBridge Capital and the Carlyle Group made in Korea First Bank and KorAm Bank respectively.

⁶⁹³ See, e.g., “Vice-minister of MOFE said, ‘The Government may take measures to stabilize the exchange rate and we should be careful about increasing interest rates.’” *eDaily*, April 17, 2006 (stating that Tae-Shin Kwon, the second vice-minister of Finance and Economy, held a negative view toward designating Belgium as a tax haven) [Exhibit C-420].

⁶⁹⁴ “Withholding taxes on tax-evading companies,” *Dong-A Ilbo*, April 26, 2006 [Exhibit C-122].

⁶⁹⁵ “Withholding taxes on tax-evading companies,” *Dong-A Ilbo*, April 26, 2006 [Exhibit C-122].

designate specific foreign investors as “tax-avoiding companies,” without regard to where they were based.⁶⁹⁶ The bill’s “Reason for Proposal” makes clear that its proponents were dissatisfied that the special withholding regime for designated tax havens would be inapplicable to certain “companies that have clearly abused the Tax Agreement . . . or foreign corporations that have made a certain type of investment (fund, etc.).”⁶⁹⁷ The sponsor of the bill, Mr. Ooh, frankly stated, “We have no intention of hiding that the bill is targeting Lone Star.”⁶⁹⁸

347. The Korean politicians’ fears that Lone Star would not be covered by the new “tax haven” law were soon confirmed. On May 3, 2006, an official of MOFE was quoted as saying that: “[t]he possibility of [the] minister’s designating Belgium as a tax haven is very low at the moment,” adding that not a single country has categorized Belgium as a tax haven.⁶⁹⁹ On June 28, 2006, MOFE confirmed that Belgium would not be categorized as a tax haven for purposes of Korea’s new tax withholding regime.⁷⁰⁰ The senior Ministry official who made the announcement acknowledged that the Ministry “had abandoned the attempt to designate Belgium as a tax haven and ha[d] begun discussions about amending the bilateral double taxation avoidance treaty with the Belgian government instead.”⁷⁰¹ The official explained that “[d]esignating a friendly trade partner as a tax haven is a matter of extreme delicacy, and

⁶⁹⁶ See Bill to Partially Amend the Corporate Tax Act, Bill No. 4298, April 21, 2006 [Exhibit CA-262].

⁶⁹⁷ Bill to Partially Amend the Corporate Tax Act, Bill No. 4298, April 21, 2006 [Exhibit CA-262].

⁶⁹⁸ “Withholding taxes on tax-evading companies,” *Dong-A Ilbo*, April 26, 2006 [Exhibit C-122]. The sponsors’ attempt to pass this bill apparently failed. As an unnamed MOFE official noted when the bill was introduced, there were no international precedents for targeting individual funds in this way. He remarked, “There is also a lot of room for controversy as the bill targets particular funds.” Email with KEB Daily Updates for April 26, 2006, News clipping of article: “Tax Evasion Bill Has Lone Star in Mind,” *Dong-A Ilbo Daily*, April 26, 2006 [Exhibit C-295].

⁶⁹⁹ “Taxing Lone Star Still Uncertain,” *Korea Times*, May 3, 2006 [Exhibit C-347].

⁷⁰⁰ “Lone Star Avoids Withholding Tax,” *Korea Times*, June 28, 2006 [Exhibit C-354].

⁷⁰¹ “Lone Star Avoids Withholding Tax,” *Korea Times*, June 28, 2006 [Exhibit C-354].

categorizing Belgium as a tax haven poses a threat of incurring sizable damage to bona fide investors.”⁷⁰²

348. This was the political context for the four tax assessments at issue in this arbitration. The public outrage and increasing politicization of Lone Star’s tax bill put immense pressure on the NTS to cut into Lone Star’s investment returns, regardless of any legal constraints the NTS might face. This set the stage for the NTS, with the encouragement of the media, activist groups, politicians, and the Blue House, to abandon the rule of law and impose taxes on Claimants’ investments under any imaginable theory. Over the ensuing years, the NTS ambushed Lone Star from every angle and assessed taxes in unlawful, contradictory, and even overlapping ways. As explained in further detail below, the only consistent theme across the NTS’s tax assessments is that the NTS improperly disregarded Claimants and ignored Korea’s treaty obligations to Belgium in order to maximize the Korean tax liability of the various Lone Star entities. Moreover, the NTS took additional extraordinary positions to further maximize tax, even if doing so required it to ignore relevant facts, misconstrue Korea’s laws and treaties, and arbitrarily change its arguments from year-to-year or investment-to-investment.

2. Introduction to the Fundamental Principles of International Tax Law Relevant to This Arbitration

349. To frame the discussion of the specific tax assessments at issue in this arbitration, we first introduce and broadly define several fundamental concepts of tax law and the core principles that are in issue. These include: (i) an overview of capital gains and dividends, (ii) the widespread use of bilateral income tax treaties to facilitate international trade and investment, (iii) the concept of a “permanent establishment” for purposes of domestic taxation of foreign

⁷⁰² “Lone Star Avoids Withholding Tax,” *Korea Times*, June 28, 2006 [Exhibit C-354].

enterprises, and (iv) the use of withholding to collect taxes on certain cross-border payments of income. These concepts are well-established in international tax law and are incorporated in national tax regimes around the world.

a. Categories of Income

350. A taxpayer can earn income in a number of ways, and governments frequently tax different forms of income differently. For example, business profits are taxed one way, and investment income (*e.g.*, capital gains and dividends) are taxed another way. In this Section, we define capital gains and dividends, which are the two forms of income most relevant in this arbitration, and explain how they are taxed.

351. A capital gain arises from the sale of a capital asset. The amount of the gain is equal to the excess of the amount realized by the seller of the asset over the seller's basis in the asset, which for this discussion can simply be thought of as the price paid by the seller for the asset. For tax purposes, a capital asset may be an asset held for investment, like stocks or land, or an asset used in a business, such as equipment or machinery. The capital assets relevant to the discussion here are shares of stock in four Korean corporations in which Claimants invested.

352. Dividend income arises when a corporation distributes earnings to its shareholders. The dividends relevant here were paid to Claimants by the Korean companies that Claimants owned.

353. As discussed below and further explained in the opinions of Dr. Luc De Broe and Professor Chang Hee Lee, when countries negotiate bilateral income tax treaties they typically restrict the taxation of capital gains from sales of shares of stock to the country where the seller resides and limit the tax rate that a country can impose on dividends paid by a company in one

country to a recipient in another country. The same is true in the Korea-Belgium Tax Treaty, as well as in Korea's tax treaties with many other trading partners.

b. Bilateral Tax Treaties

354. Bilateral income tax treaties are an essential component of international taxation. Tax treaties are agreements concluded between two States to promote international trade and investment. Tax treaties allocate the right to tax specified categories of income between the State in which the recipient of the income resides ("Residence State") and the State that is the source of the income ("Source State").⁷⁰³

355. Much like bilateral investment treaties, one of the primary purposes of tax treaties is to facilitate capital flows and investment.⁷⁰⁴ Whereas bilateral investment treaties do so by establishing legally enforceable norms for fair and non-discriminatory treatment of foreign investments, tax treaties incentivize foreign investment by offering investors certainty as to how their investment will (or will not) be taxed in the Source State.⁷⁰⁵ To provide certainty that a foreign investment will not be subject to double taxation when the investment returns are repatriated, tax treaties allocate the right to tax such income between the Source State and the Residence State.⁷⁰⁶ Common allocation provisions include exemptions from taxation by the

⁷⁰³ See De Broe Expert Opinion at para. 43 ("In view of avoiding double taxation, such treaties provide for the allocation between the treaty partners of the rights to tax, which may either be exclusive or shared between treaty partners.") [Exhibit CWE-011].

⁷⁰⁴ See De Broe Expert Opinion at para. 43 ("The elimination of international double taxation leads to the promotion of the exchange of goods and services. Furthermore, it also facilitates the movement of persons and of capital, by limiting source taxation that might otherwise act as a deterrent to cross-border investments.") [Exhibit CWE-011].

⁷⁰⁵ See De Broe Expert Opinion at para. 1 (noting that "double taxation is a very serious impediment to the development of cross border trade and investment and hampers the cross-border movement of persons and capital") [Exhibit CWE-011].

⁷⁰⁶ See De Broe Expert Opinion at para. 1 [Exhibit CWE-011].

Source State on certain types of income (usually capital gains) and reduced tax rates on other types of income (dividends, royalties, etc.).⁷⁰⁷

356. As in investment treaty arbitration, one concern relating to the scope of tax treaties is a practice commonly referred to as “treaty shopping.” In the tax treaty context, this simply describes the concern that for a certain stream of income, an intermediate entity will claim a treaty benefit to which the true owner of the income would not otherwise be entitled. States are free to include anti-avoidance exceptions in their tax treaties to limit treaty benefits as they see fit, and a host of possible measures exist. Among these is the “beneficial ownership” requirement, which restricts treaty benefits when a resident of one State receives passive income from a source in the other contracting State but has no ownership of, or power over, the income. States incorporate these anti-avoidance measures in tax treaties in a bilateral fashion, either when negotiating or amending the treaty. As Dr. Luc De Broe explains, States may not override tax treaties unilaterally with domestic anti-avoidance measures, as doing so violates bedrock principles of international treaty law.⁷⁰⁸

357. Korea and Belgium entered into a tax treaty in 1977 that was consistent with the OECD’s model income tax treaty at that time. The Korea-Belgium Tax Treaty remains a standard, unremarkable treaty that is similar in most respects to Korea’s other tax treaties. Most tax treaties, including the Korea-Belgium Tax Treaty, apply a default rule that grants the right to tax capital gains only to the Residence State.⁷⁰⁹ In the present case, this means that Belgium, not Korea, had the right to impose tax on the capital gains that Claimants earned from their Korean

⁷⁰⁷ See De Broe Expert Opinion at para. 44 [Exhibit CWE-011].

⁷⁰⁸ See De Broe Expert Opinion at paras. 66, 96 [Exhibit CWE-011].

⁷⁰⁹ See De Broe Expert Opinion at para. 44 [Exhibit CWE-011].

investments. That should have been the case with respect to each of the tax assessments that are the subject of Claimants' claims, as discussed below.

358. Most tax treaties, including the Korea-Belgium Tax Treaty, permit the Source State to tax dividends, interest, and royalties but impose a reduced tax rate on those items of income.⁷¹⁰

359. With respect to business profits, most tax treaties, including the Korea-Belgium Tax Treaty, prohibit Source State taxation unless the business is regularly conducted through a fixed place of business in the Source State.⁷¹¹ This fixed place is referred to as a "permanent establishment" in the Source State. The concept of a "permanent establishment" under international tax law is discussed in more detail below.

360. Korea and Belgium opted to incorporate a "beneficial ownership" requirement, mentioned above, for dividend, interest, and royalty income under the Korea-Belgium Tax Treaty.⁷¹² But despite contemporaneous suggestions from the OECD in 1977 to consider anti-avoidance provisions for other categories of income,⁷¹³ Korea and Belgium did not choose to implement any limitation on the exemption of capital gains taxation by the Source State when

⁷¹⁰ See De Broe Expert Opinion at para. 44 [Exhibit CWE-011].

⁷¹¹ See De Broe Expert Opinion at para. 58 [Exhibit CWE-011].

⁷¹² See Korea-Belgium Tax Treaty, Art. 10(2) (limiting taxation by the Source State to no more than 15%, but only where the resident of the other State is "the beneficial owner of the dividends") [Exhibit CA-264]; see also De Broe Expert Opinion at para. 106 [Exhibit CWE-011].

⁷¹³ See De Broe Expert Opinion at para. 106 (discussing the OECD's recommendation to include a special provision for real estate holding companies) [Exhibit CWE-011].

concluding the Tax Treaty, and they did not do so when amending the Tax Treaty in either 1994 or 2010.⁷¹⁴

361. In sum, Belgium and Korea chose to incorporate certain rights and obligations in their Tax Treaty but not others. Tax treaties are binding international agreements subject to the Vienna Convention on the Law of Treaties (“VCLT”).⁷¹⁵ As Dr. Luc De Broe explains, “treaty benefits have to be granted under the VCLT principle of ‘*pacta sunt servanda*’, even if a State considers this an improper result.”⁷¹⁶ In the event circumstances change and the treaty text is no longer suitable, the State’s proper, and only, recourse in that event is to renegotiate or terminate the treaty.

c. Permanent Establishment

362. A permanent establishment (“PE”) is a fixed place of business within a jurisdiction that can give rise to domestic tax liability on income earned within that jurisdiction by an entity that would otherwise be classified as a non-resident.⁷¹⁷ Where a permanent establishment exists, the Source State is entitled to tax the business profits that are attributable to

⁷¹⁴ See De Broe Expert Opinion at para. 106 (“Unlike many other Korean treaties, the Treaty does not provide for a specific LOB-provision against conduit companies. The Treaty was amended in 1994 and in 2010. On none of these occasions did Korea prevail upon its Treaty partner, Belgium, to amend the Treaty to the effect that Korea could apply its domestic anti-avoidance rules to abusive cases, nor was Article 13 (Capital Gains) completed with a ‘*beneficial ownership*’-requirement or a specific LOB against treaty shopping by conduit companies.”) [Exhibit CWE-011].

⁷¹⁵ See generally Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331 (“VCLT”) [Exhibit CA-074]. Korea acceded to the VCLT on April 27, 1977 and formally became a party to the treaty on January 27, 1980 when the VCLT entered into force. See United Nations Treaty Collection, Chapter XXIII Law of Treaties, Vienna Convention on the Law of Treaties Information at 332 [Exhibit CA-074]. Article 31(1) sets forth the general rule for interpreting treaties, stating that a treaty “shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” VCLT at Art. 31(1) [Exhibit CA-074].

⁷¹⁶ De Broe Expert Opinion at para. 17 [Exhibit CWE-011]. The Korean Constitution acknowledges the importance of complying with treaty obligations and provides that duly signed and ratified treaties are self-executing and have the same effect as Korean statutes. See Lee Expert Opinion at para. 25 [Exhibit CWE-012].

⁷¹⁷ See De Broe Expert Opinion at paras. 35, 176 [Exhibit CWE-011]; Lee Expert Opinion at paras. 14 [Exhibit CWE-012].

the non-resident's permanent establishment in the same (or similar) manner as it would tax a domestic business.⁷¹⁸ So, for example, if a Belgian resident has a permanent establishment in Korea, then Korea could directly tax the income attributable to that permanent establishment at Korean domestic corporate tax rates.

363. The central question in determining whether a permanent establishment exists is whether the foreign-based business maintains a fixed place in the Source State through which it regularly conducts business.⁷¹⁹ The threshold inquiry in this instance is whether the Claimants' limited investment activities in Korea constitute a "business." Professor Chang Hee Lee answers that question in the negative: "It is fundamental that a PE does not result from mere investment activities."⁷²⁰

d. Withholding Tax

364. A withholding tax is an indirect tax that imposes an obligation on the payer of certain types of passive income to collect tax on behalf of the government by withholding a portion of the proceeds due to the payee. The primary purposes of imposing a withholding tax are to ease the administration of the tax laws and prevent tax evasion. To enforce this regime, when a government determines that the payer did not withhold sufficient funds, it can assess the deficiency on the payer, regardless of whether the payer has recourse to the payee for

⁷¹⁸ See De Broe Expert Opinion at para. 176 ("PE is a concept that exceptionally allows a source country to tax commercial or industrial income – that is, operating business income – generated in that country by a non-resident enterprise (such as an enterprise established in another country).") [Exhibit CWE-011].

⁷¹⁹ See De Broe Expert Opinion at para. 176 [Exhibit CWE-011].

⁷²⁰ Lee Expert Opinion at para. 14 [Exhibit CWE-012]; see also De Broe Expert Opinion at para. 188 [Exhibit CWE-011]. Traditional permanent establishments include branches, places of management, offices, factories, mines, and other fixed locations from which an enterprise conducts industrial or commercial activities. See De Broe Expert Opinion at para. 176 [Exhibit CWE-011]. Alternatively, a non-resident business entity may be deemed to have a permanent establishment when it has an agent in the Source State who regularly exercises authority to enter into contracts on its behalf. See *id.* at paras. 176, 187 [Exhibit CWE-011].

reimbursement of the tax. Not surprisingly, it is common for a payer's contract with a payee to require the payee to indemnify the payer in the event of such after-the-fact tax assessment.

365. Withholding taxes are imposed in the context of certain international transactions. These transactions include cross-border payments of dividends, royalties, and other forms of income from resident payers to foreign payees as well as to capital gains on sales of assets (such as shares of stock) if such gains are not exempted from tax pursuant to a treaty.⁷²¹ The main purpose for this withholding requirement is to prevent tax evasion by non-residents over whom the government otherwise may have difficulty enforcing its tax laws.⁷²² Because a non-resident with a PE in the Source State by definition has substantial in-country business operations that are subject to the jurisdiction of domestic tax authorities,⁷²³ there is less of a risk of tax evasion. Therefore, direct taxation is imposed when the income in question is associated with a PE in the Source State, while withholding taxes are reserved for cases in which the foreign payee is not subject to direct taxation by the Source State.⁷²⁴

366. The key lesson to be drawn for purposes of the discussion below is this: (a) direct taxation predicated on an assertion of a PE, and (b) indirect taxation of investment income (such as dividends and capital gains on the sale of shares) through withholding tax, are *mutually exclusive* concepts under Korean tax law – they cannot both apply to the same item of income at the same time.⁷²⁵ In other words, (i) business profits of a nonresident are subject to direct

⁷²¹ See Lee Expert Opinion at Appendix 2: Korean Income Tax Act, Art. 126 (Taxable Income and Tax Calculation for Non-Residents Taxed by Withholding) [Exhibit CWE-012].

⁷²² See Lee Expert Opinion at para. 148 (noting that where withholding tax applies, there is no requirement to file a tax return) [Exhibit CWE-012].

⁷²³ See Lee Expert Opinion at para. 217 [Exhibit CWE-012].

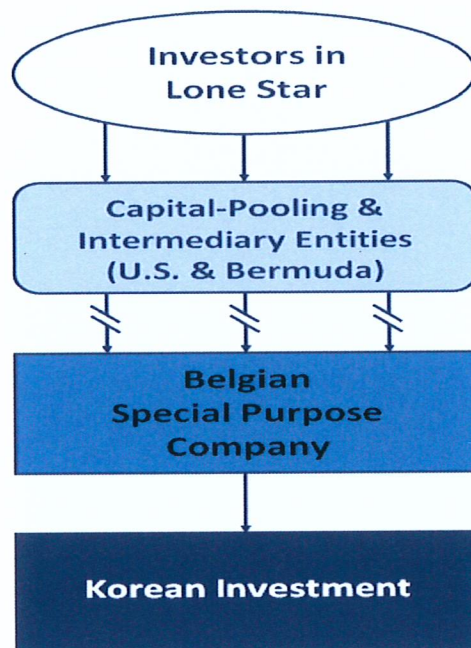
⁷²⁴ See Lee Expert Opinion at para. 217 [Exhibit CWE-012].

⁷²⁵ See Lee Expert Opinion at para. 217 [Exhibit CWE-012].

taxation to the extent attributable to a PE in Korea, while (ii) investment income of a nonresident, not associated with a PE in Korea, is subject to withholding taxes.⁷²⁶ Of course, both forms of taxation may be further limited by treaty. As described below, when Respondent sought to circumvent the protections afforded by the Korea-Belgium Tax Treaty by finding that Lone Star had a PE in Korea, it had to pretend as if Claimants' investment income was in fact business profits arising from a fixed place of business in Korea.

3. Overview of Lone Star's Investment Structure

367. We next outline Lone Star's basic investment structure. Lone Star deployed the same basic structure for each of its investments in Korea, as illustrated in the following diagram:



⁷²⁶ See Corporate Income Tax Law of the Republic of Korea ("CITL"), Art. 98(1) ("Whoever pays to a foreign corporation Korean sourced income described in Articles 93..(9) through (11) that is *not effectively connected to the domestic place of business* or not attributable to the domestic place of business ...must withhold the following amount as withholding taxes and pay them to the jurisdictional tax office..." (emphasis added)), *quoted in* to Lee Expert Opinion, Appendix 2; *see also id.* at para. 217 [Exhibit CWE-012].

368. For each investment fund, Lone Star raised capital from individual and institutional investors and aggregated the capital in limited partnerships, granting each investor a limited partner interest. A U.S.-based limited partnership was used for U.S. investors and a Bermuda-based limited partnership was used for non-U.S. investors.⁷²⁷ Further, a Bermudan corporation through which Lone Star’s employees could participate in the investments co-invested with the limited partnerships. Additional Bermudan limited partnerships were also used to facilitate co-investments, enabling single investors to participate in specific investments. (In this Memorial, we will refer to these first-level entities collectively as the “capital-pooling entities.”)

369. The investment capital from the Capital Pooling Entities then flowed through several intermediary entities, each of which served a distinct function (*e.g.*, integrating capital contributed separately by co-investors in the fund). The pooled funds were then, over time, invested in various investments around the world, including as pertinent to this case, in Belgian special purpose companies (“SPCs”) (*i.e.*, the Claimants) that acquired and held each Korean investment target.⁷²⁸ These Belgian SPCs were organized as Belgian SCAs (*société en commandite par actions*).⁷²⁹ Professor Chang Hee Lee notes that Lone Star’s use of SPCs within its structure is standard practice for foreign investment firms: “It is a prudent and unavoidable

⁷²⁷ For Lone Star’s investment in KEB, it did not aggregate capital from non-U.S. investors in a single Bermuda limited partnership; instead, co-investors, both U.S. and non-U.S., participated in the investment through six single-use special purpose partnerships, which were organized as Bermuda limited partnerships.

⁷²⁸ Because Lone Star specialized in high-risk distressed assets, it was important to ensure robust segregation of liability between investments. For that reason, each investment in Korea was owned separately by one or more SPCs.

⁷²⁹ See Claimants’ Corporate Structure Charts [Exhibit C-303].

business practice universally followed over the world by investment funds, as well as a requirement of law in many instances.”⁷³⁰

370. Lone Star made four Korean investments that form the basis of the tax issues in this Section: STC, KEB, Kukdong, and Star Lease. These four investments gave rise to tax assessments relating to investment income arising from the following:

- a. the sale of shares in STC in 2004;
- b. the sale of shares in Kukdong and Star Lease and the sale of a 13.6% block of the shares in KEB in 2007, along with the dividends paid by KEB, Kukdong, and Star Lease between 2004 and 2007;
- c. the dividends paid by KEB between 2008 and 2011; and
- d. the sale of the remaining 51% of shares in KEB in 2012.

371. For purposes of Korean taxation, the structures for all of the investments in issue were identical in all relevant respects.⁷³¹ This point is not controversial. The NTS has confirmed its view that the fund structures that Lone Star used for its various investments in Korea were the same for tax purposes. For example, on June 17, 2013, the NTS filed a legal brief in ongoing Korean litigation concerning the taxes withheld from LSF-KEB’s 2012 sale of its remaining interest in KEB to Hana. Although the case involved the investment in KEB, the NTS argued that Lone Star had used the “same investment structure” for LSF-KEB as it did when it invested in STC.⁷³²

⁷³⁰ Lee Expert Opinion at para. 102 [Exhibit CWE-012].

⁷³¹ See Claimants’ Corporate Structure Charts [Exhibit C-303].

⁷³² See Seoul Administrative Court, Case No. 2012*Guhap*39544, Cancellation of Denial of Request for Tax Refund, Defendant’s Brief, June 17, 2013 (“Defendant’s Brief, SAC, Case No. 2012*Guhap*39544”) at 13 (“In fact, Lone Star acquired real property or shares in Korea through the same investment structure shown in this case and the Star Tower case . . .”) [Exhibit C-299].

372. The fact that the structures that Lone Star used for each of Claimants' investments did not differ in any material way for Korean tax purposes is important because it underscores the capriciousness of the NTS's inconsistent and contradictory treatment of those investments in order to maximize the tax burden imposed. Despite the virtual uniformity of the structures in all cases, the NTS applied different, and inconsistent, approaches in clear violation of international and domestic law. As Professor Chang Hee Lee observes, "the inconsistency [is] remarkable."⁷³³

4. Basic Features of the Four NTS Tax Assessments at Issue

373. Claimants' claims for unlawful and arbitrarily imposed taxes relate to four categories of income realized by the Claimants from these investments, which are summarized below. The purpose of this Section is only to set forth the basic features of each assessment. The next Section explains in more detail how these four assessments, when considered collectively and with a focus on the practical effect of each evolution in the NTS's position, demonstrate that the NTS deliberately targeted Lone Star for punitive, contradictory, and unlawful tax assessments.

a. The 2004 STC Sale

374. In 2001, Claimant Star Holdings purchased all of the shares in a Korean company, STC, that in turn bought Star Tower, a large office building in Seoul, Korea. The acquisition was funded primarily with capital from investors aggregated in three capital-pooling entities that

⁷³³ Lee Expert Opinion at para. 268 [Exhibit CWE-012].

indirectly owned Star Holdings.⁷³⁴ In December 2004, Claimant Star Holdings sold its controlling interest in STC, earning significant capital gains on the sale.

375. On December 15, 2005, the NTS assessed approximately KRW 112 billion⁷³⁵ in taxes on these capital gains.⁷³⁶ The NTS acknowledged that the income was investment income (capital gains) earned by a foreign entity. According to the NTS, however, Star Holdings was nothing more than a “conduit company” that could be disregarded. The NTS thereby sought to deny the full tax exemption for capital gains to which Star Holdings was entitled under Article 13 of Korea-Belgium Tax Treaty. The NTS looked past the Belgian company and identified the U.S. and Bermudan investment entities as the purported “correct” taxpayers for this income. Because Korea does not have a tax treaty with Bermuda, the NTS taxed the investment proceeds attributable to the Bermudan investment entities at the full non-treaty rate. For the proceeds attributable to the U.S. capital-pooling partnership, although the Korea-U.S. Tax Treaty is identical to the Korea-Belgium Tax Treaty in terms of its treatment of capital gains from the sale of shares of stock, the NTS incorrectly argued that the United States and Korea had reached an agreement, not reflected in the treaty itself, which allowed the NTS to tax the capital gains in question.⁷³⁷ Thus, by treating the investment entities as the substantive owners, and by finding

⁷³⁴ These were Lone Star Fund III (U.S.) L.P. and Lone Star Fund III (Bermuda) L.P. A Bermudan co-investment entity, HudCo Partners Korea, Ltd., also held an interest in Star Holdings.

⁷³⁵ All tax amounts in the Memorial include both national and local income taxes (if applicable). The local income tax is generally 10% of the national income tax and assessed within 1-2 months from the assessment of national income tax. For the taxes collected through withholding tax, the national and local income taxes are paid on the same date.

⁷³⁶ See Tax Assessment Notice to Lone Star Fund III (U.S.) L.P. Concerning the Star Tower Sale, December 15, 2005 [Exhibit C-355]; Tax Assessment Notice to Lone Star Fund III (Bermuda) L.P. Concerning the Star Tower Sale, December 15, 2005 [Exhibit C-356]; Tax Assessment Notice to HudCo Partners Korea, Ltd. Concerning the Star Tower Sale, December 15, 2005 [Exhibit C-357].

⁷³⁷ This purported “agreement” pertained to so-called Korean “real estate holding companies,” which are Korea companies whose assets are comprised primarily of real property. However, as explained in Professor Chang Hee Lee’s report, there was no such agreement and, absent a modification to the Korea-U.S. Tax Treaty, taxation by the NTS of a U.S. resident on such gain was prohibited. Professor Chang Hee Lee explains in more detailed the

an agreement with the United States effectively to amend the treaty that did not exist, the NTS assessed tax on the entirety of the gains from the sale of STC.

376. The NTS's disregard of Star Holdings was a drastic departure from the NTS's approach just two years earlier with regard to other, similarly structured Lone Star investments in Korea.⁷³⁸ In 2003, prior to the public outcry that precipitated the tax audit in 2005, in 2003 the NTS conducted an intensive audit of Lone Star's Korea operations, which at the time consisted largely of asset-backed securities ("ABS") companies that worked out distressed non-performing loans and real estate.⁷³⁹ This investment ownership structure was essentially the same as the investments in issue here, except that the holding companies were organized in Luxembourg, rather than in Belgium.⁷⁴⁰ As Mr. Thomson recalls, this tax audit "was resolved amicably with payment of a relatively nominal amount of additional tax."⁷⁴¹ Mr. Thomson explains the significance of these "clean" tax audits for present purposes:

The Korea-based ABS companies would periodically pay dividends to their Luxembourg-based parent companies. Pursuant to the Korea-Luxembourg Tax Treaty, the ABS companies would withhold taxes on those dividend payments at the treaty-reduced rate of 10%. The NTS raised no issues with the 10% withholding rate that was applied to these dividend payments, thus

historical context of the NTS's erroneous determination that Korea could tax capital gains earned on shares in companies that qualify as real estate holding companies (or "real-estate rich companies" in the Korean) in his expert opinion. See Lee Expert Opinion at paras. 120-28 [Exhibit CWE-012]. The salient point for present purposes is that the NTS developed a theory, by *applying* the tax treaties relevant to the upper-tier entities, to avoid application of any treaty benefits on the sale of STC.

⁷³⁸ See Thomson Witness Statement at para. 28 (noting that, light of the amicable conclusion of the 2003 audit, the "ferocity of this tax audit caught us completely by surprise") [Exhibit CWE-007].

⁷³⁹ See Thomson Witness Statement at para. 28 [Exhibit CWE-007].

⁷⁴⁰ See Thomson Witness Statement at para. 28 [Exhibit CWE-007].

⁷⁴¹ Thomson Witness Statement at para. 28 [Exhibit CWE-007]; see also 2003 Tax Audits of Lone Star's Asset-Backed Securities Companies, October 22, 2003 [Exhibit C-366].

acknowledging the Luxembourg SPVs' right to the benefits of the Korea-Luxembourg tax treaty.⁷⁴²

377. After the public outcry against foreign private equity funds politicized the question of taxing such entities, however, the NTS abruptly changed course without notice or reasoned explanation for its change in policy with regard to recognizing tax treaty benefits.⁷⁴³

378. Yet another flaw in the NTS's approach to taxation was that it assessed tax under Korea's Income Tax Act ("ITA" or personal income tax) the rate for which was significantly higher than the Corporate Tax Act ("CTA" or corporate income tax). After years of litigation, the Korean Supreme Court ruled that the NTS erred in imposing the personal, rather than the corporate, income tax rate on the two capital-pooling limited partnerships; however, on February 13, 2012, the NTS simply re-issued its tax assessments on the STC sale with respect to those partnerships under the corporate tax rate, while maintaining its other baseless arguments discussed above.⁷⁴⁴

b. The 2007 Sale of Shares in KEB, Kukdong, and Star Lease and Related Dividends from 2004-2007

379. In 2002 and 2003, five of the Claimants purchased shares of stock in KEB, Kukdong, and Star Lease.⁷⁴⁵ Similar to Star Holdings, these Claimants were primarily funded and indirectly owned by several capital-pooling entities based in the United States and

⁷⁴² Thomson Witness Statement at para. 28 [Exhibit CWE-007].

⁷⁴³ See Thomson Witness Statement at para. 29 (noting that in 2005, the NTS also reversed itself with regard to the tax treatment for the very same ABS companies it had so rigorously audited just two years prior) [Exhibit CWE-007].

⁷⁴⁴ See Tax (Re-)Assessment Notice to Lone Star Fund III (U.S.) L.P. Concerning the Star Tower Sale, February 13, 2012 [Exhibit C-358]; Tax (Re-)Assessment Notice to Lone Star Fund III (Bermuda) L.P. Concerning the Star Tower Sale, February 13, 2012 [Exhibit C-359].

⁷⁴⁵ LSF-KEB Holdings SCA purchased shares in KEB, LSF SLF Holdings SCA and HL Holdings SCA purchased Star Lease, and Kukdong Holdings I SCA and Kukdong Holdings II SCA purchased Kukdong.

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OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

Bermuda.⁷⁴⁶ Between 2004 and 2007, these Korean companies paid dividends to their respective Claimants and withheld tax at the 15% preferential rate specified under the Korea-Belgium Tax Treaty.⁷⁴⁷ The NTS did not question withholding tax at this rate as it was reported and paid over to the NTS (including when the NTS audited and challenged the taxation of the STC sale in 2005, discussed above). When Claimants sold their stakes in Kukdong and Star Lease in full, as well as a block of shares in KEB in 2007, Claimants earned substantial capital gains.

380. Shortly after these sales, in August 2007, the NTS commenced another intrusive tax audit of Lone Star's operations.⁷⁴⁸ In July 2008, the NTS concluded its audit, assessing approximately KRW 160 billion in taxes on Lone Star's capital-pooling entities.⁷⁴⁹ While apparently triggered by Claimants' significant share sales in the summer of 2007, the NTS's audit included dividends paid from 2004-2007. The NTS justified these taxes on the unprecedented theory that these U.S.- and Bermuda-based capital-pooling entities somehow maintained a PE in Korea and that the capital gains and dividends were business profits attributable to that PE.⁷⁵⁰

⁷⁴⁶ Lone Star Fund IV (U.S.), L.P. invested in all three investments, as did Bermudan co-investment entities for employees. Lone Star Fund IV (Bermuda), L.P. invested in Kukdong and Star Lease. Six Bermudan special purpose partnerships, LSF IVB Korea I L.P., LSF IVB Korea II L.P., KEB Investors, L.P., KEB Investors II, L.P., KEB Investors III, L.P., and KEB Investors IV, L.P., invested in KEB and had both U.S. and non-U.S. investors as limited partners.

⁷⁴⁷ KEB paid dividends in 2007. Kukdong paid dividends in 2004, 2005, and 2006. Star Lease paid dividends in 2006.

⁷⁴⁸ See Seoul Administration Court Judgment, Case No. 2010Guhap36824, 2012Guhap13627, February 8, 2013, at 5 (noting that the Seoul Regional Tax Office conducted a tax audit from August 22, 2007, to May 23, 2008) [Exhibit C-297].

⁷⁴⁹ Seoul Administrative Court Judgment, Case No. 2010Guhap36824, 2012Guhap13627, February 8, 2013 [Exhibit C-297]; see also Letter from Joon-soo Song, Deputy Director of the International Investigation Division, Seoul Regional Tax Office attaching tax assessment table, July 4, 2008 (announcing a total national tax liability of KRW 153,414,349,150 and an estimated local tax (i.e., residence tax) liability of an additional KRW 5,536,993,100) [Exhibit C-196].

⁷⁵⁰ As Professor Chang Hee Lee explains, the NTS unlawfully and incorrectly argued that 21% of the gains from the 2007 sales and 100% of the dividends from 2004-2007 were attributable to a permanent establishment based on

381. The NTS had already collected 11% of the purchase price of the KEB shares from Credit Suisse, who served as the broker for that sale and thus was, under Korean tax law, the withholding tax agent with respect to the sale. Keenly aware of the Korean anti-foreign investment sentiment, Credit Suisse insisted on withholding tax at the Korean domestic tax law rate, despite the clear applicability of the Korea-Belgium Tax Treaty's capital gains exemption, in order to avoid getting drawn into the by-then very public battle between the Korea tax authority and Lone Star.⁷⁵¹ When Claimant LSF-KEB requested a refund of these withheld funds, the NTS failed to respond within the statutory deadline. LSF-KEB petitioned the National Tax Tribunal, but it denied the refund request.⁷⁵² The NTS applied this withholding tax against the tax liability it found based upon its later permanent establishment determination, but in recent filings with the Seoul Administrative Court the NTS has taken the inexplicable and indefensible position that it may not refund the withholding tax even if the courts ultimately reject the permanent establishment tax assessment.⁷⁵³ Thus, the NTS is simultaneously pursuing two mutually exclusive taxes on the same income—withholding based on the lack of a PE and direct taxation based on the presence of one.

unsupported allegations concerning the activities of certain LSAK and HAK officers. The 21% ratio was calculated using the number of days that those officers were in Korea as directors of LSAK and HAK over the total number of days of the investment. *See* Lee Expert Opinion at para. 171 [Exhibit CWE-012]. Not only did the NTS completely reverse its position with respect to the STC sale in 2004 (where it found no permanent establishment), the NTS assessed additional permanent establishment-based tax (on top of that already withheld and remitted) on the dividends, some of which were paid in 2004, *in the very same year as the STC sale*. *See id.* at paras. 212-15 [Exhibit CWE-012].

⁷⁵¹ Email Chain Regarding Credit Suisse's Decision to Withhold Taxes from the Proceeds of the Block Sale of KEB Shares, May to June 2007 [Exhibit C-154].

⁷⁵² *See* Korean National Tax Tribunal decision, *Kookshim2007Seo5223*, July 21, 2010 [Exhibit C-157]. LSF-KEB's appeal to the Seoul Administrative Court is pending: 2010*Guhap*38684.

⁷⁵³ Seoul Administrative Court, Case No., 2010*Guhap*38684, Defendant's Brief, September 17, 2013, at 3 [Exhibit C-027].

382. Just as for the assessment on the STC sale, the NTS unlawfully imposed the higher personal income tax rate, rather than the corporate rate, for these assessments. Following the Korean Supreme Court's ruling in the STC case, the NTS canceled the original assessments and promptly issued new ones based on the corporate rate on February 13, 2012.⁷⁵⁴

c. The 2012 Sale of the Remaining Shares in KEB

383. As described in detail in Section III.J of this Memorial, after years of frustration and delay at the hands of the FSC, LSF-KEB finally was able to sell its 51% stake in KEB to Hana in early 2012.

384. As news spread that Lone Star's long delayed exit from its KEB investment was imminent, the NTS sprang into action. Not content to wait until after the taxable event had occurred, the NTS made several preemptive forays into the media to disclose how it planned to impose "strict taxation" on the proceeds of Lone Star's 51% stake in KEB⁷⁵⁵ and was "willing to let things get ugly if that's what it take to force Lone Star to pay up."⁷⁵⁶ According to media reports, the NTS was considering a "dual approach" to taxing the proceeds.⁷⁵⁷ This involved merging two mutually exclusive methods of taxation— withholding and direct taxation—in a way that maximized the tax burden on Lone Star:

⁷⁵⁴ Tax (Re-)Assessment Notices Concerning the 2004-2007 Tax Audit, February 13, 2012 [Exhibit C-360].

⁷⁵⁵ See, e.g., "Considering Imposing Corporate Tax of KRW 600 Billion against Lone Star," *Hankyung Economic Daily*, November 24, 2011 (reporting that "[a]ccording to the tax authorities and the financial industry on November 23, the NTS is leaning towards assessing tax at a rate of 24.2% (corporate tax plus resident surtax) on [Lone Star's] capital gains" and quoting an NTS official as claiming that "when the sale [of KEB to Hana] is finally concluded, there will be strict taxation pursuant to the law") [Exhibit C-094]; "Tax Audit Sword Will Be Drawn against 'Tax Evading Lone Star,'" *Seoul Economic Daily*, December 5, 2011 (quoting an unnamed high-level government official as stating that "as the sale of KEB is almost completed, the NTS is planning to conduct an extensive audit of Lone Star" and "the scope of the tax audit will expand from KEB to both domestic and foreign affiliates and relevant companies of Lone Star") [Exhibit C-224].

⁷⁵⁶ "Lone Star, Tax Agency Prepare for Renewed Bout," *Korea Times*, December 6, 2011 [Exhibit C-225].

⁷⁵⁷ "NTS Expects 2nd Tax War with Lone Star," *eDaily*, November 9, 2011 [Exhibit C-421].

The tax authority, judging that Lone Star's Korean assets are only the KEB shares and Lone Star will very likely to try to avoid tax on its sale of the KEB shares, plans to first secure withholding tax on the capital gains from the sale of the KEB shares and thereafter prove a deemed permanent establishment ("PE") on the basis of the KEB personnel appointed by Lone Star and then assess corporate tax against Lone Star.⁷⁵⁸

385. The article goes on to quote an anonymous NTS official, who brushes off the inconsistency of this "dual approach," stating:

[O]ne may think that it is impossible to assess both withholding tax and corporate tax against Lone Star since only one or the other can be assessed depending upon whether or not a PE exists, but it is not true that only one of them should be chosen.⁷⁵⁹

386. That Lone Star had effectively closed down its servicing companies in Korea years before apparently was no barrier to NTS finding that Lone Star had a PE in Korea. The official was quoted as stating that "even if Lone Star closed its Korean business in 2008, there is still evidence that Lone Star has a deemed PE in Korea."⁷⁶⁰ It is hard to fathom what this official may have had in mind to support this assertion. Finally, the article stated that the NTS was considering the "extraordinary" measure of pre-notifying Hana, the buyer of Lone Star's stake, of its obligation to withhold taxes from the sale proceeds.⁷⁶¹

387. Indeed, as forewarned, on January 18, 2012, Hana received a letter titled "Notice of the obligation to withhold tax on gains from the alienation of shares by a foreign corporation" from the NTS's Seoul Regional Tax Office, stating that Hana should withhold capital gains tax

⁷⁵⁸ "NTS Expects 2nd Tax War with Lone Star," *eDaily*, November 9, 2011 [Exhibit C-421].

⁷⁵⁹ "NTS Expects 2nd Tax War with Lone Star," *eDaily*, November 9, 2011 [Exhibit C-421].

⁷⁶⁰ "NTS Expects 2nd Tax War with Lone Star," *eDaily*, November 9, 2011 [Exhibit C-421].

⁷⁶¹ "NTS Expects 2nd Tax War with Lone Star," *eDaily*, November 9, 2011 [Exhibit C-421].

from the sale price of the KEB shares before payment to LSF-KEB.⁷⁶² This letter instructed Hana to withhold taxes on the sale as though *neither* the Korea-Belgium Tax Treaty *nor* any other tax treaty was applicable.⁷⁶³

388. Hana of course followed the NTS's instructions. Although LSF-KEB strongly disagreed with this position, it weighed the risk of holding up (and thereby possibly dooming) its sale to Hana against the looming sale order deadline and the FSC's months of unwarranted delay in approving the sale, and concluded that it would have to accept (temporarily) the NTS's demand and pursue a refund after the sale. Thus, LSF-KEB relented, acknowledging in a side letter that Hana would hold back over KRW 430 billion from the amount payable at closing and pay such amount to the NTS.⁷⁶⁴ Hana paid the withholding taxes to the tax authorities on March 5, 2012, and LSF-KEB is now seeking a refund in the Korean courts.

d. The 2008-2011 KEB Dividends

389. In March 2013, after Respondent became aware that Claimants would commence an investor-State arbitration against Korea under the BIT, the NTS retroactively imposed withholding taxes and penalties on Citibank Korea, Inc. ("CKI") for failing to withhold tax at the maximum domestic rates⁷⁶⁵ when CKI remitted KEB dividends to LSF-KEB from 2008-2011. CKI had already duly withheld and paid tax on the KEB dividends at the 15% preferential rate provided in the Korea-Belgium Tax Treaty based on LSF-KEB's status as a *bona fide* Belgian

⁷⁶² Letter from the Seoul Regional Tax Office to Hana Financial Group Inc. providing "Notice of the obligation to withhold tax on gains from the alienation of shares by a foreign corporation," January 18, 2012 ("SRTTO Withholding 'Guidance' to Hana") [Exhibit C-361].

⁷⁶³ See SRTTO Withholding 'Guidance' to Hana [Exhibit C-361].

⁷⁶⁴ See Side Letter from LSF-KEB to Hana Concerning Closing on the SPA dated December 3, 2011, February 9, 2012, at 2-3 [Exhibit C-151].

⁷⁶⁵ The non-treaty tax rate on dividends was 27.5% in 2008 and 22% for 2009-2011. Lee Expert Opinion at para. 279 [Exhibit CWE-012]. These tax rates are inclusive of local income tax rates.

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

resident. After abandoning any remaining pretense of legitimacy with its withholding tax assessment on the 2012 sale of KEB shares, the NTS felt free to exact one final, confiscatory blow on Lone Star's investment profits without even offering a legal basis or seeking to identify which entity it was taxing. The NTS again denied that *any* tax treaty applied and even imposed late payment penalties on CKI for failing to disregard, on its own accord, LSF-KEB's status as a *bona fide* Belgian resident.⁷⁶⁶ The NTS's position this time was that the dividends are investment income and not business profits attributable to a PE (in contrast to their position regarding dividends received from KEB in 2007).

390. The following table summarizes the key characteristics of the four transactions at issue:

⁷⁶⁶ See Tax Assessment Notice to Citibank Korea Concerning Withholding on Dividends 2008-2011, March 11, 2013 [Exhibit C-144]; Local Tax Assessment Notice to Citibank Korea Concerning Withholding on KEB Dividends 2008-2011, May 10, 2013 [Exhibit C-300].

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

Transaction	Date of Contested NTS Assessment	Actual Income Type	Korea-Belgium Tax Treaty Result	NTS: Respect Belgium Tax Treaty?	NTS: Alleged Taxpayer	NTS: Permanent Establishment ?	NTS: Taxes Assessed/Withheld Above Belgian Treaty Rates
2004 Star Tower Sale	13-Feb-12	Capital Gains	0%	No	US LP & Bermuda entities	No	KRW 110,977,546,760
2007 Share Sales & 2004-2007 Dividends	13-Feb-12	Capital Gains	0%	No	US LP & Bermuda entities	Yes (21% of gains attributed to PE)	KRW 193,977,977,902
	13-Feb-12	Dividends	15%	No	US LP & Bermuda entities	Yes (100% of dividends attributed to PE)	
2008-2011 KEB Dividends	11-Mar-13	Dividends	15%	No	None	No	KRW 113,506,560,080
2012 KEB Sale	5-Mar-12	Capital Gains	0%	No	None	No	KRW 430,716,857,640

5. The NTS's Targeting of Claimants for Arbitrary and Punitive Tax Assessments

391. In this Section, we explain how the four tax assessments summarized above demonstrate that the NTS targeted Lone Star's investments for arbitrary, abusive, and confiscatory taxation.

a. The NTS Unlawfully and Incorrectly Disregarded the Belgian Claimants as the Owners of Lone Star's Investment Income

392. As discussed above, Lone Star organized its investments by pooling funds in upper-tier investment entities and forming SPCs under those entities (such as Claimants) to directly own and manage the Korean target investments. Throughout the period of Lone Star's investments in Korea, Claimants fully complied with the Korean tax laws and the Korea-Belgium Tax Treaty. While the Tax Treaty exempted capital gains from taxation in Korea, it imposed a withholding tax of 15% on dividends paid by a Korean corporation. For the taxable

years in dispute, Claimants timely paid (via withholding tax) taxes on these dividends in excess of KRW 267 billion; however, this was seen as insufficient by the NTS. The public sought taxation of capital gains and, as discussed above, the government promised to deliver.

393. To tax the capital gains earned by Claimants, the NTS had to disregard the Korea-Belgium Tax Treaty, and the way the NTS did that was by claiming that Claimants were sham entities. This, however, was no easy feat. The Tax Treaty was clear on its face that its benefits applied to all Belgian residents.⁷⁶⁷ There can be no sensible dispute that Claimants were (and are) *bona fide* residents of Belgium and, in fact, the Belgian government so certified on several occasions.⁷⁶⁸ Indeed, the Belgian government took several steps, some extraordinary, in its attempt to persuade the NTS that Claimants were *bona fide* residents of Belgium. As discussed below, the Belgian government requested direct regulator-to-regulator meetings to discuss the issue in accordance with the Korea-Belgium Tax Treaty (a request that Respondent refused, in violation of its treaty obligations). Additionally, the Belgian Ministry of Finance issued formal certificates. For example, a formal “Certificate on permanent residence” for Claimant LSF-KEB was issued that unambiguously confirmed that LSF-KEB:

is a resident of the Kingdom of Belgium for tax purposes in 2006 within the meaning of the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect for taxes on incomes between the Government of the Republic of South KOREA and the Government of the Kingdom of Belgium signed at Brussels on August 29 1977.⁷⁶⁹

⁷⁶⁷ Korea-Belgium Tax Treaty, Art. 4(1) [Exhibit CA-264].

⁷⁶⁸ See LSF-KEB Holdings, SCA Certification of Permanent Residency from Belgium, May 24, 2006 [Exhibit C-396]. The Belgian government issued a similar certificate for Claimant Star Holdings a year-and-a-half earlier. See Star Holdings, SCA Certification of Permanent Residency from Belgium, December 16, 2004 [Exhibit C-396].

⁷⁶⁹ LSF-KEB Holdings, SCA Certification of Permanent Residency from Belgium, May 24, 2006 [Exhibit C-396].

394. At each turn, however, the NTS simply refused to listen, which culminated in the Kingdom of Belgium taking the unusual step of filing a brief in support of Claimants in one of the Korea domestic court tax litigations (discussed more fully below).

395. In addition, the Korea-Belgium Tax Treaty was clear that, while Korea and Belgium had agreed to include the then-standard anti-avoidance provisions requiring that interest, dividends, and royalties be beneficially owned by a resident of either State to be eligible for treaty protection, no such requirement was included with respect to capital gains. The Tax Treaty could not have been clearer: Capital gains “shall be taxable only in the Contracting State of which the alienator is a resident.”⁷⁷⁰

396. As Dr. Luc De Broe discusses in his opinion, the Korea-Belgium Tax Treaty has been modified twice since its ratification, and on neither occasion was an anti-avoidance provision added with respect to capital gains.⁷⁷¹ In fact, the latest amendment occurred in 2010, in the midst of the NTS’s attacks on Lone Star and other foreign investments. The absence of a specific provision, together with Belgium’s clear stance that the Claimants are entitled to the benefits of the treaty, makes clear that the two countries did not intend to relinquish taxation rights to Korea in this situation.

397. That is, of course, not to say that an anti-avoidance provision would have restricted the treaty benefits in this case. As discussed in detail below, there were business reasons for establishing Claimants, Claimants performed *bona fide* business activities, and

⁷⁷⁰ Korea-Belgium Tax Treaty, Art. 13(3) [Exhibit CA-264].

⁷⁷¹ De Broe Expert Opinion at para. 22 (“Although the Treaty was amended in 1994 and in 2010, on none of these occasions did Korea take the opportunity to amend it to the effect that Korea could apply its domestic anti-avoidance rules to abusive cases, nor was Article 13 (Capital Gains) amended to include a “*beneficial ownership*”-requirement or a specific [limitations on benefits]-clause against treaty shopping by conduit companies.”) [Exhibit CWE-011].

Claimants were not formed primarily for tax avoidance purposes. Simply put, Claimants were not sham companies and could not simply be ignored.

398. Like the Korea-Belgium Tax Treaty, Korean law was also an obstacle to taxing the capital gains earned by Claimants. First, while Korea had a general anti-abuse rule in the form of the substance-over-form doctrine that seeks to determine whether the substance of the transaction is different than the form that the transaction takes, all that meant that a transaction would be respected unless it was fraudulent or otherwise defective as a matter of law.⁷⁷² Second, as a legal matter, the application of this domestic law doctrine by Korea would directly conflict with the treaty that Korea and Belgium had negotiated.⁷⁷³ As noted above, the sole limitation that Korea and Belgium chose to include in the treaty was a beneficial ownership requirement for certain types of passive income other than capital gains.⁷⁷⁴ The NTS could not rely on Korea's domestic substance-over-form rules to override or impose tax in contravention of the Korea-Belgium Tax Treaty.

399. Notwithstanding these restrictions, the NTS relentlessly and improperly pursued its mandate to impose tax, and to do this it had to disregard the *bona fide* existence of Claimants. Thus, without regard to the Korea-Belgium Tax Treaty, the NTS asserted not only that it could apply a domestic law doctrine in violation of its treaty obligations to Belgium, but also that its domestic substance-over-form doctrine could be applied based on the economic activities of the Belgian entity rather than on whether Belgian entity was legal and the transaction was not

⁷⁷² See Lee Expert Opinion at para. 10 [Exhibit CWE-012].

⁷⁷³ See De Broe Expert Opinion at para. 110 (concluding that “the application by the Korean Tax Authorities of their substance-over-form-rule to deny the existence of the Belgian holding companies and attribute the Korean source income derived by those companies to other alleged owners of that income conflicts with the common intentions of Belgium and Korea when signing the Treaty in 1977 and amending it in 1994 and thus is a breach of the Treaty”) [Exhibit CWE-011].

⁷⁷⁴ See De Broe Expert Opinion at para. 107 [Exhibit CWE-011].

fraudulent. That is, the NTS argued that it could disregard Claimants (even though they were *bona fide* legal entities organized under the laws of Belgium) because Claimants allegedly (i) served no valid business purpose and performed no business functions, *and* (ii) were formed solely or primarily for tax avoidance.

400. This two-prong analysis, referred to as the “economic substance-over-form” doctrine, was not previously accepted by the Korean Supreme Court. In recent years with respect to foreign investment cases, the Korean Supreme Court has become more accepting of this expanded doctrine.⁷⁷⁵ But even if this newly expanded interpretation of Korea’s domestic substance-over-form doctrine were applicable, the NTS’s assertion that Claimants satisfy both of the two prongs of this doctrine is factually incorrect. Each prong will be addressed separately.

401. With respect to Claimants’ business purpose and functions, as Professor Chang Hee Lee explains, using Claimants to own its Korean investments on a segregated basis allowed Lone Star to, among other things, (i) segregate assets and protect the assets of one investment from creditors of another and (ii) individually monitor and manage the investment profits from each asset.⁷⁷⁶ Indeed, the use of SPCs to hold segregated investments is widely regarded as the norm in international investments.⁷⁷⁷

402. Additionally, while an SPC can be, and often is, a paper company, this was not the case with respect to Claimants. Rather, Claimants through their manager maintained a physical office and a qualified workforce within Belgium. There were as many as 21 employees in Claimants’ Brussels office for the years at issue, with their activities divided into two broad

⁷⁷⁵ See Lee Expert Opinion at para. 10 [Exhibit CWE-012].

⁷⁷⁶ See Lee Expert Opinion at para. 103 [Exhibit CWE-012].

⁷⁷⁷ See Lee Expert Opinion at para. 104 [Exhibit CWE-012].

categories: (i) investment analysis and (ii) statutory reporting and tax. Additionally, by a qualified board of directors oversaw all operations and made decisions for the entities, and the entities filed all annual tax returns and financial statements required under Belgium law. At all relevant times, Claimants and other Lone Star investment affiliates occupied a sizeable office at 9 Boulevard de la Plaine in Brussels, Belgium. This was not a “letterbox office” of the type typically found in tax havens, in which an independent company with very limited personnel and facilities may officially house hundreds (or even thousands) of investment companies. This was an active Lone Star investment office, housing only Lone Star affiliates and conducting meaningful substantive investment-related activities. Professor Chang Hee Lee fully concurs that the NTS had no basis for disregarding the legitimate business functions performed by the Belgian Claimants, opining that “the facts squarely establish that [Claimant Star Holdings] was not a sham but, rather, was formed for and performed *bona fide* business activities.”⁷⁷⁸ A more complete discussion of the Belgian operations is set forth in Professor Chang Hee Lee’s opinion.⁷⁷⁹

403. The photograph below, taken on December 17, 2008, shows the Claimant’s employees in front of the office in Brussels, and the red box highlights Lone Star Capital Management’s sign.

⁷⁷⁸ Lee Expert Opinion at para. 87 [Exhibit CWE-012].

⁷⁷⁹ See Lee Expert Opinion at paras. 80-87 [Exhibit CWE-012].



404. A list of the employees' names, employment dates, and education levels is set forth below.⁷⁸⁰

Belgium Employee Data (as of October 15, 2009)

Name	Status	Start	End	Level of education
Darquennes Paul	D	15-Jul-01	28-Oct-05	Bachelor
Detournay Philippe	A	15-Aug-03		Bachelor
Westbrook Lynne	T	1-Aug-03	8-Jul-07	Master
Jacob Valérie	R	1-Sep-03	15-Apr-06	Master
Leclercq Lionel	A	13-Oct-03		Master
Deschrijver Lieven	R	16-Feb-04	7-Apr-06	Master
Buffet Paul-Henri	R	14-Jun-04	15-Dec-05	Master
Robert Marie-Sophie	R	11-Oct-04	11-Apr-05	Master
Lisapaly Mona	A	16-Jun-05		Master
Balych Sophiya	R	8-Aug-05	15-May-08	Master
Van Hauwaert Samuel	D	9-Sep-05	30-Sep-08	Bachelor
Peeters Caroline	A	20-Sep-05		Master
Dominiguez Sabrina	R	3-Oct-05	17-Mar-06	Bachelor

⁷⁸⁰ See Belgium Employee Data [Exhibit C-424]. Because Lone Star had a policy of using separate investment holding companies for each investment, it was more practical from a business standpoint for the investment holding companies to be *société en commandite par actions* ("SCAs"), which are analogous to limited partnerships, and have all of the employees be employed by Claimant Lone Star Capital Management (through April 22, 2009) and Lone Star Investment Management SPRL (after April 22, 2009).

**CONTAINS CONFIDENTIAL INFORMATION--MAY NOT BE USED
OR DISCLOSED OUTSIDE ICSID CASE NO. ARB/12/37**

Leonova Alla	D	4-Oct-05	15-Jan-08	Bachelor
Herzfeld Vincent	R	2-Nov-05	15-Dec-06	Master
Twagirayezu Valere	D	12-Dec-05	14-Jun-06	Master
Lundin Karl	R	1-Jan-06	11-Sep-07	Master
Webster Amy	T	16-Jan-06	31-May-07	Master
Fransolet Emmanuel	A	1-Feb-06		Master
Meurisse Myriam	R	6-Mar-06	31-Aug-08	Master
Le Doeuil Christine	R	3-Apr-06	15-May-08	Master
Amoundala Issia	D	22-May-06	24-Apr-07	Bachelor
Luchowa Sandheea	R	15-Jul-06	15-Oct-08	Bachelor
Schlarb Matthew	A	20-Sep-06		Master
Venter Martin	A	1-Feb-07		Master
Santillan Filipinas	R	27-Feb-07	22-Jun-07	Master
Domorakova Judita	R	5-Mar-07	12-Dec-08	Master
De Vos Laurent	D	27-Mar-07	31-Mar-09	Bachelor
Derevianko Vera	A	2-Apr-07		Bachelor
Izmailova Inga	A	18-Jun-07		Master
Scoupe Delphine	A	9-Jul-07		Bachelor
Komakhidze Giorgi	R	16-Jul-07	23-Oct-07	Master
Elbouazzati Noura	R	3-Dec-07	15-Aug-09	Bachelor
Bonnewijn Vincent	A	2-Jan-08		Master
Hendrickx Mike	A	2-Jan-08		Bachelor
Van Pevenaeyge Marc	A	3-Mar-08		Bachelor
D'Haeyer Cécile	A	1-Oct-08		Master
Chotimanit Supod	A	22-Oct-08		Master
Muratoglu-Gorur Senay	A	6-Jan-09		Master
Grégory Diggle	A	1-Oct-09		Bachelor
Status legend				
D = Dismissal				
A = Active				
R = Resignation				
T = Transfer to another office				

405. Second, the NTS's assertion that Claimants were *formed solely or primarily for tax avoidance* was equally baseless. Substantially all of the investors in the Lone Star funds resided in countries that had tax treaties with Korea that afforded benefits commensurate with those of the Korea-Belgium Tax Treaty. While certain of these treaties may have had less favorable provisions than the Korea-Belgium Tax Treaty with respect to so-called real property

holding companies⁷⁸¹ and would have allow Korea to tax gains from the sale of such companies, the vast majority of Claimants' gains in Korea did not relate to Korean real property holding companies. Indeed, of the four investments discussed in this Memorial, only STC involved a real property holding company and the gain in dispute in this investment is a small fraction of the total amount in dispute among these Claimants.

406. Moreover, as discussed in Professor Chang Hee Lee's report, there is a strong argument that the purported exception for real property holding companies that the NTS applied to disregard the Korea-U.S. Tax Treaty on the STC assessment is invalid. Indeed, the issue is currently pending in Korea's Constitutional Court.⁷⁸² Thus, notwithstanding less favorable treaties with respect to real property holding companies, even if the NTS disregarded the Belgian owner, Korean domestic law taxation of such gains was, at best, uncertain. In other words, Claimants were not and could not have been formed solely or primarily for tax avoidance, because virtually all the investors in the Lone Star Funds resided in other tax treaty jurisdictions and enjoyed similar tax treatment benefits with one possible (and questionable) exception that had limited application to this case.

407. Because the NTS's objective of disregarding Claimants and the Korea-Belgium Tax Treaty was contrary to law and fact, if the NTS sought to pursue that objective, it had no choice but to take extreme (and unusual) measures to advance its case. These include the NTS's ongoing misrepresentation of the relevant facts. For example, notwithstanding the fact that Claimants' business operations in Belgium were conducted by a highly-skilled and highly-

⁷⁸¹ Examples include Canada and the United Kingdom. As noted above, while the NTS asserts that the United States has conceded to Korea's taxation of such gains, this assertion is flatly incorrect.

⁷⁸² See Lee Expert Opinion at para. 55 [Exhibit CWE-012].

educated workforce, the NTS continues to take the position that Claimants are mere paper companies that performed no valid business functions and served no valid business purpose.

408. Apparently, even the NTS was aware that its allegation that Lone Star's Belgium office was nothing more than a "paper company" was based on dubious factual and legal foundations, because it flatly refused even to meet its Belgian counterparts in an effort to resolve this dispute. On August 6, 2007, Claimant Star Holdings formally requested the Belgian Competent Authority under the Korea-Belgium Tax Treaty to enter into a mutual agreement procedure ("MAP") with its Korean counterparts to resolve the dispute concerning the NTS's tax assessment on the capital gains from the STC sale.⁷⁸³ A MAP is a common process established by tax treaties whereby the treaty partners commit to one another that they will meet in an effort to resolve disputes in good faith. On August 8, 2007, the Belgian Competent Authority formally requested Korea to enter into the MAP under Article 24 of the Korea-Belgium Tax Treaty.⁷⁸⁴ However, on September 27, 2007, the NTS flatly denied Belgium's request.⁷⁸⁵ The NTS stated that "Even if a mutual agreement procedure starts for this case, it is very unlikely to reach a satisfactory resolution because we will be drawing a parallel line" (*i.e.*, the positions of the Parties are necessarily incompatible and cannot intersect).⁷⁸⁶

409. In an extraordinary intervention, on February 8, 2010, the Belgian government submitted a brief as *amicus curiae* (friend of the court) in the litigation before the Seoul High

⁷⁸³ Request on behalf of Star Holdings to the Belgian Federal Public Service – Finance requesting initiation of mutual agreement procedures under the Korea-Belgium Tax Treaty, August 6, 2007 ("Star Holdings MAP Request") [Exhibit C-160].

⁷⁸⁴ See Letter from Korean NTS to Belgian Administration of Corporate and Income Tax Denying MAP Request, September 27, 2007 ("NTS Rejection of MAP Request") [Exhibit C-165].

⁷⁸⁵ NTS Rejection of MAP Request [Exhibit C-165].

⁷⁸⁶ NTS Rejection of MAP Request [Exhibit C-165].

Court concerning the NTS's tax assessment on the STC sale. In that *amicus* brief, not only did the Belgian government reiterate its view that Star Holdings (one of the Claimants) was a *bona fide* resident of Belgium and the true seller of the shares at issue,⁷⁸⁷ but also noted that the NTS's "unprecedented refusal [to engage in the MAP] does not comply with either the letter or the spirit of the Treaty between the two countries."⁷⁸⁸

410. Both expert reports submitted by Claimants agree with Belgium's position in its *amicus* brief. Professor Chang Hee Lee considers Korea's failure an indictment of its treaty administration policies: "The NTS's refusal to discuss this issue with its treaty partner is improper and inconsistent with sound treaty administration."⁷⁸⁹ Dr. Luc De Broe explains that Korea's unprecedented refusal is in fact a violation of international law:

None of the reasons put forward by the Korean authorities to deny the request of their Belgian counterpart to negotiate a MAP is legitimate. Korea's categorical denial to start negotiations under the MAP is a breach of the provisions of Article 24 of the Treaty. As the obligation flowing from a '*pactum de negotiando*' (like a MAP) to negotiate with a view to concluding an agreement must be executed in good faith, Korea's refusal to start negotiations under the MAP is therefore yet another breach of the principle of "*pacta sunt servanda*" expressed in Article 26 VCLT. A violation of this principle gives rise to international responsibility of the State concerned.⁷⁹⁰

411. In yet another example of the extreme lengths to which the NTS went to support its theories for taxing Lone Star, the NTS has repeatedly insisted in its pleadings to the Korean

⁷⁸⁷ Seoul High Court Cancellation of Corporate Tax Assessment, Case No. 2009Nu8016, Brief of the Government of the Kingdom of Belgium as Amicus Curiae in support of plaintiff, February 8, 2010 ("Belgium's Amicus Brief, SHC, Case No. 2009Nu8016"), at 2-4 [Exhibit C-218].

⁷⁸⁸ Belgium's Amicus Brief, SHC, Case No. 2009Nu8016m at 1 (emphasis added) [Exhibit C-218].

⁷⁸⁹ Lee Expert Opinion at para. 87 [Exhibit CWE-012].

⁷⁹⁰ De Broe Expert Opinion at para. 174 [Exhibit CWE-011].

courts that it is “common knowledge that Belgium is one of the international tax havens.”⁷⁹¹

This position directly contradicts the formal declaration of MOFE that Korea has “abandoned the attempt to designate Belgium as a tax haven,” after taking into “consideration the fact that there is no country that designates Belgium as a tax haven in making its decision.”⁷⁹² Dr. Luc De Broe observes the lack of any merit for the claim that Belgium is a tax haven and notes the hypocrisy in Korea’s claim: “Korea can . . . hardly pretend that Belgium is a tax haven . . . [since Korea] itself applies a similar regime.”⁷⁹³

412. In short, the NTS could attain its goal of maximizing Lone Star’s Korean tax bill only by disregarding the Belgian Claimants and thereby denying the application of the Korea-Belgium Tax Treaty. By relying on a domestic anti-avoidance provision, Korea breached its treaty obligations to Belgium, and in doing so, violated international treaty law. Further, the NTS blatantly misapplied its anti-avoidance rule, both legally and factually, first by requiring that Claimants have not just legal substance but also economic substance, and second by erroneously arguing that Claimants performed no business functions and were located in Belgium solely for tax avoidance purposes. At bottom, the NTS’s determination to disregard the Belgian Claimants, which is the basis for each of the unlawful tax assessments at issue, was patently wrong, arbitrary, and designed with the specific intent of maximizing Claimants’ tax liability.

⁷⁹¹ See, e.g., Defendant’s Brief, SAC, Case No. 2012*Guhap*39544, at 12 [Exhibit C-299].

⁷⁹² “Lone Star Avoids Withholding Tax,” *Korea Times*, June 28, 2006 [Exhibit C-354]; see also “Withholding taxes on tax-evading companies,” *Dong-A Ilbo*, April 26, 2006 (“According to the current Corporate Tax Act, it is practically difficult to withhold the taxes on Lone Star’s capital gains from the sale of Korea Exchange Bank because it is impossible to designate Belgium as a tax haven country.”) [Exhibit C-122].

⁷⁹³ De Broe Expert Opinion at para. 79 [Exhibit CWE-011].

b. After Avoiding the Korea-Belgium Tax Treaty, the NTS Advanced Its Goal of Maximum Tax by Misinterpreting the Other Tax Treaties Applicable to the Ultimate Investors

413. Because the NTS's disregard of Claimants' tax residency and Korea's corresponding obligations under the Korea-Belgium Tax Treaty was founded on the fiction that Claimants performed no business activities or functions and were formed for tax avoidance purposes, a consistent application of that theory would mandate that the NTS disregard the entirety of the Lone Star investment structure. Indeed, if the NTS disregarded Claimants, then it logically should have disregarded all other entities within the Lone Star Funds' global structure, which (unlike Claimants) were actually paper companies without any employees. However, if the NTS took that consistent and logical approach, then the ultimate investors⁷⁹⁴ would have to be considered the beneficial owners. The problem for the NTS with this result is that the vast majority of these ultimate investors resided in States that also had tax treaties with Korea that afforded comparable treaty benefits. As a result, any income attributable to these investors would be subject to the very treatment the NTS was trying to avoid. The fatal flaw in the NTS's tax avoidance argument would thereby be exposed, undermining its attempts to impose massive taxes.

414. The NTS was going to argue that Claimants were organized in Belgium for tax avoidance purposes, the NTS would have to either arbitrarily identify another entity within the structure as the substantive owner in lieu of Claimants or take the equally unsupported approach that it could simply pretend as if no person or entity was the substantive owner and, thus, no tax treaties apply. Astonishingly, over the course of these investments, NTS took both positions. In

⁷⁹⁴ By ultimate investors, we refer to the individuals, pension funds, university endowment foundations, and others who invest their funds in Lone Star's fund-pooling entities. In most cases, these ultimate investors are limited partners in the main two capital-pooling entities, one based in the United States and the other in Bermuda. *See See Claimants' Corporate Structure Charts [Exhibit C-303].*

two of the transactions—the sale of STC in 2004 and the sale of Kukdong, Star Lease, and a block of shares in KEB in 2007 (and dividends paid by those entities from 2004-2007)—the NTS argued that the highest-tier U.S. and Bermudan investment entities were the substantive owners of the capital gains and/or dividend income. However, with respect to the sale of the remaining 51% interest in KEB in 2012 and the dividends paid by KEB from 2008-2011, the NTS simply pretended that there was no substantive owner entitled to treaty benefits at all. Thus, the NTS took the position that it could cherry-pick the substantive owner further up the chain of ownership, or pretend that there was no substantive owner at all, depending on what best suited its purpose of levying the highest amount of taxes.

415. Although inconsistent, the NTS's positions were not by happenstance. Rather, where the NTS believed that it could apply the maximum amount of taxation notwithstanding the treaty in the State in which the capital-pooling entities were organized,⁷⁹⁵ the NTS asserted that the capital-pooling entities were the substantive owners. Where the NTS believed that the application of the treaty in the State in which the capital-pooling entities were organized, or in the States in which the ultimate investors resided, would restrict taxation in Korea, the NTS ignored all treaties and imposed tax as if there were no substantive owner.

416. This stark and irrational position can be seen in the NTS's inconsistent treatment of the sale of STC in December 2004 and the sale of KEB in February 2012. The STC investment involved a Korean real property holding company and, notwithstanding the fact that the Korea-U.S. Tax Treaty is virtually identical in this regard to the Korea-Belgium Tax Treaty,

⁷⁹⁵ As noted above, the investment partnerships were organized in the United States and Bermuda and there is no treaty between Korea and Bermuda. Thus, if the application of a treaty was determined at the partnership (as opposed to the partner level), which, as discussed below, it is not, only the Korea-U.S. Tax Treaty would be relevant.

the NTS argued that the United States and Korea had previously agreed that Korea may nevertheless impose tax on capital gains earned by U.S. residents on the sale of shares of a Korean real property holding company. Thus, the NTS identified the U.S. and Bermudan investment entities as the substantive owners and imposed tax on the entirety of the gains from the sale. The errors in the NTS's position with respect to the agreement between Korea and the United States are discussed above and in detail in Professor Chang Hee Lee's opinion and, thus, need not be reiterated here. What is important, however, is that the NTS used this argument to tax gains that should have been exempt from Korean taxation under the Korea-U.S. Tax Treaty, and then used that tax as a basis for arguing that Lone Star had a tax avoidance motive for organizing Star Holdings (one of the Claimants) in Belgium. That is, the NTS misconstrued the law to create a taxing right (which did not exist) and then used that taxing right to impute a motive for establishing Claimants in Belgium.

417. By contrast, the KEB investment did not involve a Korean real property holding company. Thus, when LSF-KEB sold its shares of KEB in 2012, the NTS knew that it could not impose tax if it identified the capital-pooling entities as the purported "substantive owners" of the capital gains, as it had for the 2007 Share Sales and Star Tower assessments, because over 50% of the investment returns were attributed to the U.S. capital-pooling limited partnership. Moreover, if treaty benefits were applied at the level of the ultimate investors, almost 90% of the KEB gains would not be taxable in Korea. Thus, the NTS reversed its position and simply refused to identify a substantive owner and denied all treaty benefits. Again, the significance of this reversal, beyond highlighting the arbitrary positions that the NTS took in its result-oriented approach of maximizing taxation, is that the NTS took an unsupportable position to create a

taxing right (again, which did not exist) and then used that taxing right to impute a motive for establishing Claimants in Belgium.

418. Yet another way the NTS sought to bolster its tax avoidance argument was to propose tax at the highest possible rates. For the sale of STC and the 2007 sales of Kukdong, Star Lease, and a block of shares in KEB (and the dividends paid by those companies from 2004-2007), the NTS assessed tax under Korea's ITA (or personal income tax) the rate for which was significantly higher than the CTA (or corporate income tax). As explained in Professor Chang Hee Lee's opinion, there is no rational basis on which the NTS could have concluded that the entities that it was seeking to tax could be subject to the ITA. More precisely, the ITA is limited to individuals and non-profit organizations (*e.g.*, a church). Professor Chang Hee Lee explains the patent absurdity of the NTS's position, noting that "it is simply impossible to find any legal basis for the NTS's original disposition of imposing 36% income tax under the ITA to the [capital-pooling limited partnerships]."⁷⁹⁶

419. Finally, as discussed in detail in both Professor Chang Hee Lee's and Dr. Luc De Broe's expert reports, partners in a partnership are typically entitled to the benefits of the treaties applicable in their State of residence. More particularly, most States view a partnership as a fiscally transparent entity whose income "flows through" the partnership and is attributable to the partners. As such, the relevant treaty benefits are determined by the State in which the *partner* resides and not the State in which the *partnership* is organized. Thus, even though Bermuda does not have a tax treaty with Korea, because Canada treats a Bermuda limited partnership as fiscally transparent, a Canadian partner in that Bermudan partnership is entitled to

⁷⁹⁶ Lee Expert Opinion, at para. 147 [Exhibit CWE-012].

the benefits of the tax treaty between Korea and Canada. Consequently, the NTS cannot ignore the benefits afforded by the tax treaties between Korea and the countries in which the ultimate investors (*i.e.*, the limited partners) reside, merely because the NTS arbitrarily declares the capital-pooling limited partnerships to be the substantive owners.

c. The NTS Changes Course and Assesses Tax Under an Unprecedented PE Theory

420. Another inconsistent and erroneous argument made up by the NTS to facilitate taxation is its unprecedented theory that certain of Lone Star's investments in Korea (but not others) constituted business activities that were routinely performed within Korea (*i.e.*, a permanent establishment). As noted above, KEB did not involve real property and substantially all of the investment (approximately 90%)⁷⁹⁷ would be exempt from taxation in Korea even if the NTS improperly disregarded Claimants and denied them benefits of the Korea-Belgium Tax Treaty. The same was true with respect to the investments in Star Lease and Kukdong. In order to tax any entity within the investment structure on these gains, the NTS had to come up with a new theory or adopt the unsupportable fiction that there was simply no substantive owner (*i.e.*, that no treaties applied).⁷⁹⁸

421. As discussed above, Korean politicians had already vowed to decimate Lone Star's investment profits through Korean tax assessments, but Korea's ambitions were constrained by its domestic laws and treaty obligations. Boxed in, the Korean government publicly debated a number of avenues to target Lone Star's profits. The NTS ultimately settled

⁷⁹⁷ See Lee Expert Opinion at paras. 151, 265 (noting that about 90% of the capital gains and 95% of the dividends from the 2007 Share Sales would have been entitled to treaty protection at the ultimate investor level and 87.6% of the investors in KEB would be entitled to a treaty-based exemption on capital gains) [Exhibit CWE-012].

⁷⁹⁸ As noted above, the NTS took the position in the 2012 sale of KEB that no treaty benefits applied. However, for the 2007 sale (and related dividends) it advanced yet another theory.

on claiming that the capital-pooling partnerships had permanent establishments in Korea through which they conducted business and that a significant portion of Claimants' investment income was actually business profit attributable to the capital-pooling partnerships' permanent establishments.⁷⁹⁹

422. This theory of taxation was not only counter to and incompatible with the NTS's prior tax assessment on the STC investment, it was also unprecedented.⁸⁰⁰ That is, other than Lone Star, Claimants are not aware of any tax assessments by the NTS against foreign investment funds that were actively investing in Korea on the basis of a permanent establishment theory during the same timeframe.

423. In fact, in the case of Newbridge's acquisition, management, and disposal of its investment in Korea First Bank ("KFB"), the NTS affirmatively argued that investment activity cannot give rise to a permanent establishment in Korea. In that case, the NTS opted to make a withholding tax assessment on the transferee of the KFB shares, *not* an assessment on Newbridge based on a permanent establishment. That decision was challenged in court by the withholding agent, and the court agreed that the withholding was appropriate (*i.e.*, there was no PE). Despite the similarities between Newbridge's investment in KFB and Lone Star's investment in KEB, the NTS argued polar opposite positions in the two cases in order to maximize Lone Star's Korean tax liability.

⁷⁹⁹ "National Tax Service Might Collect One Trillion Won in Taxes from Lone Star," *Financial News*, March 26, 2006 [Exhibit C-353].

⁸⁰⁰ Lee Expert Opinion at para. 210 ("The NTS's finding of a PE in investment by a fund is unprecedented to the best of my knowledge. Judging from the facts, I opine that finding a PE common to all Investment Partnerships is contrary to established Korean law and treaty principles. The flaws in the NTS's reasoning are numerous and manifest.") [Exhibit CWE-012].

424. Not only was the NTS's permanent establishment position legally inconsistent and unprecedented, but it was factually baseless. The NTS admitted that it *wanted* to find a permanent establishment and was gathering evidence toward that end, but in the end the evidence the NTS relied upon did not in any way support a finding of a permanent establishment. As explained above, a permanent establishment is a fixed place of business maintained in the Source Country (Korea) that can give rise to tax liability for revenue earned in the Source Country and attributable to the permanent establishment. It is fundamental, however, that permanent establishments do not result from mere investment activities; a permanent establishment requires active and continuous business activities.

425. The NTS based its permanent establishment determination on the alleged business activities performed by officers of two Lone Star-affiliated service providers, LSAK and HAK. LSAK and HAK are wholly-owned Korean subsidiaries of companies affiliated with Lone Star that provide origination, underwriting, and asset management services to Lone Star.⁸⁰¹ LSAK and HAK performed the same services with respect to each of the Claimants' investments in Korea. LSAK and HAK employees would identify target investments for Lone Star's investment management entity and collect data to inform the investment decisions. Thereafter, LSAK and HAK would provide investment acquisition support and ongoing management support for the investment assets in Korea. To that end, some of the LSAK and HAK officers were appointed as outside directors of the Korean corporations that Claimants acquired. Further, certain high-level officers of LSAK and HAK were offered co-investment interests as limited partners in Lone Star's management entity.

⁸⁰¹ Prof. Chang Hee Lee explains in greater detail in his expert opinion the structure of LSAK and HAK and the activities and employees of LSAK and HAK. See Lee Expert Opinion at paras. 223-26, 239-40 [Exhibit CWE-012].

426. The NTS alleged that the senior officers of LSAK and HAK (Steven Lee, Paul Yoo and Heon Choo Cheong) were actually acting on behalf of the capital-pooling partnerships by making final investment decisions, entering into contracts that bound the partnerships, and increasing the value of the investments in Korea for the benefit of the capital-pooling partnerships. The NTS also argued that these officers' limited partnership interests in Lone Star's management entity empowered those officers to act as general partners and thereby manage the business of Lone Star. On this ground, the NTS claimed that 21% of the capital gains in 2007 and 100% of the dividends from 2004-2007 were attributable to a permanent establishment.⁸⁰²

427. As Prof. Chang Hee Lee explains in his expert opinion, however, there was no basis for the NTS to claim that the LSAK/HAK officers gave rise to a Korean permanent establishment by the capital-pooling partnerships.⁸⁰³ First, none of the LSAK/HAK officers whose activities the NTS relied upon to find a permanent establishment made final investment decisions for Lone Star's capital-pooling partnerships. Rather, LSAK and HAK were retained to perform discrete services: LSAK performed investment origination services and HAK performed underwriting and asset management services. The retention of a mere service provider within a country, as opposed to the designation of an agent with broad powers, does not create a PE for the service recipient. Further, the officers' limited partner co-investment interests did not make them general partners of Lone Star, with the authority to act on Lone Star's behalf. Moreover, the LSAK/HAK officers' responsibilities as outside directors for the target investment companies (specifically, KEB) were not carried out for the benefit of Lone Star; rather, their

⁸⁰² The 21% attribution ratio was based in part on the number of days the LSAK and HAK officers spent in Korea divided by the total number of days of the investments. Lee Expert Opinion at para. 171 [Exhibit CWE-012].

⁸⁰³ Lee Expert Opinion at paras. 235-41 [Exhibit CWE-012].

activities were performed for the benefit of the Korean corporations for which they served as directors, and those Korean corporations paid tax in Korea based on the business profits they generated. At bottom, the business activities the officers performed with respect to Lone Star's Korean investments were rendered in their capacities as LSAK/HAK officers; and LSAK and HAK, as Korean corporations, paid Korean tax on the business income generated by these activities. These activities were not attributable to the capital-pooling partnerships.

428. More to the point, however, the scope of the origination, underwriting, and asset management activities of the LSAK/HAK officers was no different with respect to the KEB, Kukdong, and Star Lease 2002-2003 stock acquisitions, 2004-2007 dividend distributions, and 2007 sales (where the NTS found a permanent establishment) than it was with respect to the STC 2001 stock acquisition and 2004 sale (where the NTS did not find a permanent establishment). The facts that these events substantially overlap in time and that these investments utilized the same structure reveals how indefensible it is for the NTS to assess tax based on a PE for only some of Lone Star's Korean investments—the investments for which a PE theory would maximize tax.

429. In fact, the activities of LSAK and HAK officers in the year of the sales of KEB, Kukdong, and Star Lease were, if anything, significantly curtailed in comparison to 2004, when STC was sold, as the officers on whom the NTS based its finding of a PE left Korea or ceased their duties in 2005 and 2006 as a result of the criminal allegations and investigations discussed above. Moreover, as noted above, only a few months later, when KEB paid dividends to LSF-KEB in March 2008, somehow the permanent establishment that the NTS was determined to find beginning in 2004 and lasting through at least mid-2007 had disappeared. Thus, for dividends and capital gains from the exact same investment (KEB), the NTS unjustifiably reversed its

taxation theory midstream without so much as a whisper of explanation. The result of these inconsistent positions is, of course, tax maximization.

430. There was absolutely no legal or factual basis to take inconsistent approaches to the same investment structure—the only apparent reason was to maximize taxes, as illegal taxation under a permanent establishment theory was the only way the NTS and Korean politicians could deliver on their promise to the Korean public that they would confiscate Lone Star’s profits. Neither can Prof. Chang Hee Lee find any other justification for the NTS’s actions. He concludes that:

there is no evident basis for the NTS to validate a new theory. In my opinion, the invention of the completely different PE theory was the only way for the NTS to expose the [capital-pooling partnerships] to Korean taxation, given that the real property rich company carve out was not even potentially applicable to these investments.⁸⁰⁴

6. Taken as a Whole, the NTS’s Targeted Tax Treatment Was Inconsistent, Contradictory, Arbitrary, and Discriminatory

431. As shown above, the NTS had absolutely no basis for disregarding the Belgian Claimants as the substantive owners and imposing taxes in contravention of the Korea-Belgium Tax Treaty. The treaty is clear on its face and the NTS cannot unilaterally import requirements into the treaty that simply do not exist, especially over the loud objections of its treaty partner. Moreover, even assuming, *arguendo*, that the NTS could impose an economic substance-over-form doctrine to the transaction at issue, the Claimants are not shams; they performed valid business functions and activities and were not formed primarily or solely for tax avoidance purposes.

⁸⁰⁴ Lee Expert Opinion, at para. 215 [Exhibit CWE-012].

432. We have also explained above the indefensible and inconsistent approaches that the NTS has taken to maximize taxation and to attempt to support its tax avoidance allegations. These approaches have included treating the capital-pooling entities as the substantive owners at times, or simply finding no substantive owner at other times. They have also included treating the capital gains and dividends as business profits attributable to a PE at times, or treating the capital gains and dividends as investment income at other times. The end result, of course, is targeted, punitive taxation.

433. Because of the complexity of the tax issue, we have included with this Memorial two detailed expert reports that provide comprehensive analyses of the NTS's varying approaches.⁸⁰⁵ These lengthy reports conclude that the NTS's positions were inconsistent and illegal, and were formulated with the objective of imposing tax that is precluded by the Korea-Belgium Tax Treaty.⁸⁰⁶ We have quoted and cited to these reports throughout this Memorial and, as a result, we have not systematically and chronologically addressed each of the abundant improprieties in the NTS's attempts to tax the gains in question. Accordingly, in this final Section, we present in chronological form, a high-level overview of the Defendant's arbitrary and capricious positions with respect to each of the four assessments at issue.

434. In 2004, after the NTS disregarded Star Holdings, it taxed the capital-pooling entities as the substantive owners and misapplied the Korea-U.S. Tax Treaty to the U.S. limited partnership. The NTS did not assert that a permanent establishment existed, but rather based its assessments on (i) the baseless disregard of the Claimants, (ii) a corresponding refusal to honor the Korea-Belgium Tax Treaty, and (iii) a flawed argument that gains from the sale of a Korean

⁸⁰⁵ See generally Lee Expert Opinion [Exhibit CWE-012]; De Broe Expert Opinion [Exhibit CWE-011].

⁸⁰⁶ See Lee Expert Opinion at paras. 10-13 [Exhibit CWE-012]; De Broe Expert Opinion at 19 [Exhibit CWE-011].

real property holding company by U.S. residents could be taxed as a result of a (non-existent) understanding between the U.S. and Korean governments.

435. In 2007, however, the NTS disregarded the Claimants and taxed the highest-tier investment entities on the dividends and capital gains from the KEB, Kukdong, and Star Lease investments (through 2007) as business profits under a permanent establishment theory. As Professor Chang Hee Lee noted, the NTS's factually and legally baseless position was obviously motivated by the fact that, in the absence of a real property holding company, there is simply no basis on which taxation on the investment income (other than the reduced withholding tax that the Claimants properly paid in accordance with the Korea-Belgium Tax Treaty) could be justified. That is, even if the NTS could assess tax at the highest-tier investment entity level, almost half of the gains would unquestionably be exempt from Korean taxation under the Korea-U.S. Tax Treaty. If the treaty benefits were properly determined at the ultimate investor level, almost 90% of the gains would be exempt from Korean taxation. Thus, the NTS resorted to an entirely inappropriate mischaracterization of the capital gains and dividends as business profits and misconstrued (or ignored) the facts to allege that these highest-tier investment entities regularly conducted business activities through a fixed place of business within Korea (*i.e.*, a permanent establishment). That is, notwithstanding that the NTS recognized that gains in 2004 from the STC investment were investment income and that there was no PE at that time, the NTS implausibly argued that in that *very same year*, and for the three subsequent years, the dividends from Kukdong, Star Lease, and KEB, as well as the capital gains from the sale of shares in those investments, were business profits attributable to a PE.

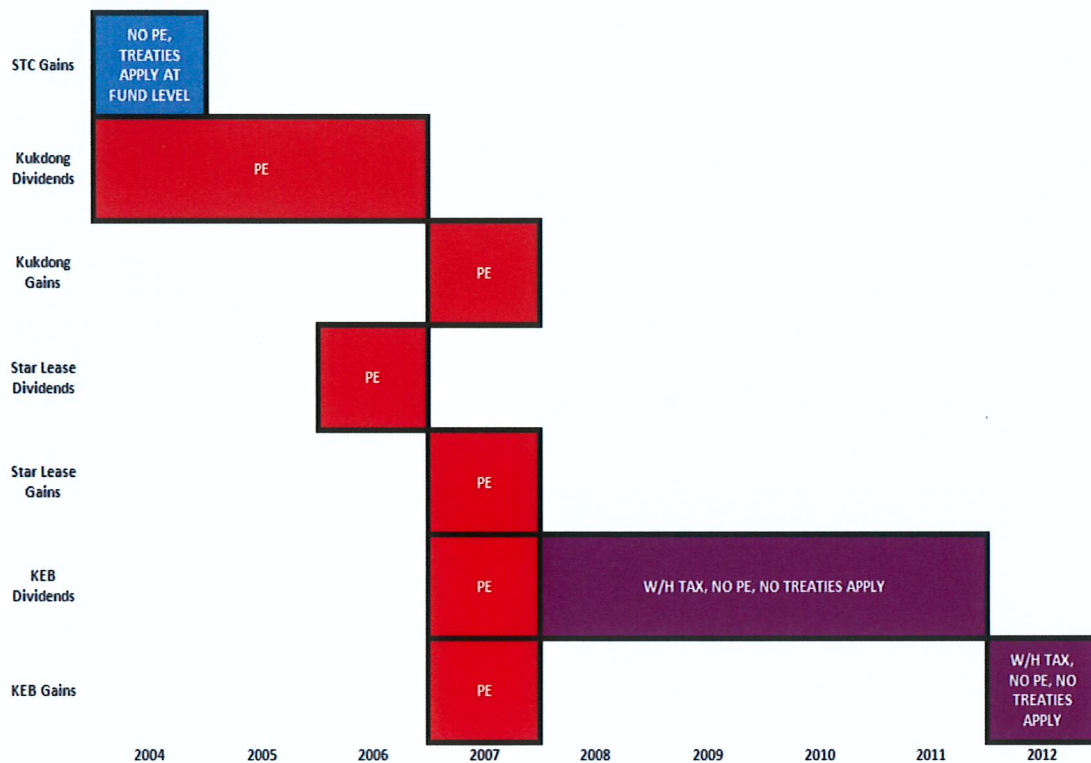
436. When the PE approach could no longer support the level of taxation that the NTS desired (presumably because the attribution formula the NTS had used in the PE assessment for

the 2007 sale of KEB would yield much lower taxes), the NTS unabashedly reversed course yet again. The NTS apparently adopted the view that, from 2008, the PE ceased to exist and the dividends and capital gains from the KEB investment transformed from business profits back to investment income. Thus, the sale of the 51% interest in KEB in 2012 was taxed under the withholding tax regime (the NTS went so far as to coerce the purchaser into withholding tax as if *no* treaty benefits applied), and the dividends from 2008 through 2011 were further taxed by the NTS in 2013 (after Korea had learned that the Claimants would bring this arbitration claim against Korea) by additional retroactively imposed withholding taxes.⁸⁰⁷

437. While the NTS circumvented the limitation on taxation that its attribution formula presented for the KEB sale in 2012, its ability to impose significant taxes was still largely restricted by the U.S.-Korea Tax Treaty and the treaties in the countries in which the ultimate investors resided. Thus, in yet another unprecedented and egregious act, the NTS astonishingly decided to proceed as if there were *no* substantive owner of the gains and dividends, and thus *no* tax treaties applied. As Professor Chang Hee Lee explains in his opinion, not only does such position clearly violate of Korean tax law and treaty obligations, it was also illegal for the NTS to instruct the purchaser of KEB to withhold on this basis as the NTS knew that certain treaties would have to apply.

438. The chart below shows the overlapping and inconsistent nature of the NTS's tax assessments.

⁸⁰⁷ Although CKI had already withheld and paid over tax on the KEB dividends under the 15% preferential rate provided in the Korea-Belgium Tax Treaty based on LSF-KEB's status as a *bona fide* Belgian resident, the NTS preposterously assessed penalties on CKI for failing to ignore LSF-KEB's entitlement to treaty benefits.



439. In sum, for all four assessments the only consistency among the NTS’s positions is that it refused to honor the provisions of the Korea-Belgium Tax Treaty. Respecting the Belgian Claimants and their entitlement to the benefits of the treaty would have precluded all of the unlawful assessments at issue, but doing so would not have permitted the NTS to deliver on its promise to impose maximum taxes on Lone Star. After denying the legitimacy of the Claimants, the NTS moved from one unsupportable theory to the next, discriminatorily targeting Lone Star’s investments in an inconsistent and arbitrary fashion with no regard for the rule of law.

IV. THE TRIBUNAL HAS JURISDICTION OVER THIS DISPUTE

440. The Tribunal has jurisdiction over this dispute under Article 8 of the Agreement Between the Government of the Republic of Korea and the Belgium-Luxembourg Economic