Corporate Governance and *Chaebol* Reform in Korea

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A typical *chaebol* consists of many diversified and legally independent affiliates, all of which are controlled by a controlling shareholder family. This paper characterizes the *chaebol* governance structure as controlling shareholder-managerialism to differentiate it from shareholder capitalism and stakeholderism. We examine the historical and institutional background that contributed to the persistence of the *chaebol* governance structure despite the gradual dilution of ownership. By regression analysis about the top 30 *chaebol*s, we also find that the *chaebols*' pyramid control structure became to reveal its limitations around the early 1990s, ane thus *chaebol* governance should have been improved even before the financial crisis. But this finding could not justify the way in which the government has initiated the governance reform since the crisis. Since the major problem of *chaebol* governance largely came from the lack of market disciplining mechanisms, the government should put more efforts in providing the appropriate environments where market mechanisms operate effectively.

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I. Introduction

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control rights over stakeholders including shareholders, board members, and managers. In a corporation where ownership and management are separate, there is always the possibility of agency problems. The corporate governance structure is a mechanism designed to reduce the conflict of interests between investors and the management thereby eliminating barriers that may hinder the growth of the value of the corporation. From an institutional viewpoint, the corporate governance issue is closely related with both formal and informal institutions such as commercial code, securities exchange law, competition policy, bankruptcy procedures, managerial convention, investors' shareholding patterns, and so on.

Since the firms play an important role in the production and allocation of scarce economic resources, the corporate governance structure has important implications for national economic performance. Many developed countries already recognized the importance of a sound corporate governance, and recently, following the economic crisis, Asian countries have begun to emphasize and improve their corporate governance structures. In Korea, the policy-oriented approach to corporate governance began in 1995. And after the outbreak of the crisis towards the end of 1997, the government has implemented a substantial amount of measures to reform corporate governance structures. However, it is still controversial whether the government-led governance reform is consistent with the historical and institutional environment of Korean economy.

We focus on the *chaebol*s in discussing Korean corporate governance structure. The *chaebol*s have greatly contributed to industrialization during the period of rapid economic growth and as such constitute an important part of the Korean economy. For example, the top 30 *chaebol*s control around half of corporate assets across almost all industries in Korea. Before the crisis in 1997, *chaebol*s were criticized as seeking excessive unrelated diversification which has been blamed as resulting in the concentration of economic power. In response, the government employed various measures to prevent *chaebol* expansion in the economy. With the advent of the recent crisis, the government and many scholars criticized inefficient *chaebol* structures as a main cause of the crisis and consequently demanded the *chaebol* to restructure themselves in every aspects including business, financial, and governance structures. Specifically, the government placed *chaebol* governance reform on top priority, and this has generated the huge controversy about the roles of government in corporate governance reform.

It should be noted that the governance structure of *chaebol* is quite different from that of a textbook firm. A typical *chaebol* consists of many widely diversified and legally independent affiliates. Some of affiliates are financially partial-interlocked. But every affiliate belonging to a *chaebol* is effectively controlled by a controlling shareholder, operating like a division of an M-form enterprise. We consider a *chaebol* as a single entity rather than a coalition of independent corporations.

This paper intends to seek answers to the following questions: What are the characteristics and peculiarities of the *chaebol* governance structure? What is the environment that has supported the governance structure in which the controlling shareholder has almost monopolized the control rights (of the whole business group) while his shareholdings have steadily decreased? Is the direction of recent reform of corporate governance appropriate? What remains to be further discussed in the area of corporate governance structure?

This paper is structured as follows: In Section II the characteristics of *chaebol*'s ownership and their governance structures are described. Section III examines in detail the historical and institutional background that contributed to the persistence of the *chaebol* governance structure. Some empirical evidence as regards the relationship between the *chaebol* governance structure and their performance is presented in Section III. In Section IV the recent reform about corporate governance is discussed and evaluated. Section V presents some remaining issues and concludes the paper.

II. Overview of *Chaebol*'s Ownership and Control

A. Pyramid Ownership Structure

A typical *chaebol* consists of many diversified and legally independent affiliates, all of which are controlled by a controlling shareholder family. The top 30 *chaebol*s have been engaged in businesses over 20 industries with more than 27 subsidiaries on average, and their assets comprise over 45% of the total corporate assets in Korea. On the other hand, the share of a controlling family has decreased from 15.8% in 1987 to 8.5% in 1997.

There are key observations that suggest the basis of *chaebol*'s ownership structure. One is that the total number of a *chaebol*'s affiliates has persistently increased from 16.4 in 1987 to 20.8 in 1995 to 27.2 in 1997 on average. On the other hand, the share of a controlling family has decreased from 17% in the early 1980s to 8.5% in 1997 and to around 5% in 1999 (see Table 1). One may reasonably ask how it is possible for the controlling shareholder to maintain full control over the whole business group despite such a small share and a persistent decline of the residual claims? Also, what is the basis of this ownership structure that supports the sustainance of such a governance structure?

Many scholars have claimed that the main feature of *chaebol* ownership structure is the cross-shareholding among subsidiaries.[1] In fact, equity-investment among subsidiaries has increased while the controlling family's share has steadily decreased. However, this argument has some difficulties in explaining the connection between *chaebol*'s ownership structure and controlling shareholder-centric governance structure. Various laws such as Commercial Code, Securities Exchange Law, and Monopoly Regulation and Fair Trade Act prohibit direct cross-shareholding. In addition, since 1987, the Fair Trade Act has regulated the top 30 *chaebol*s as regards the total amount of equity investment of *chaebol*'s affiliates, and this may impose limits on exercising indirect or circular equity investment. Moreover, some studies have shown that circular equity investments inside of a *chaebol* are rarely observed.[2] It should be also noted that Japanese business groups, largely dependent on the cross-shareholding, have horizontal cooperative structures while the *chaebol* has an authoritative and hierarchical structure. It may not be satisfactory to explain two different control systems using the same argument of cross-shareholding.

The concept of the control pyramid may help us understand the connection between *chaebol*'s ownership and internal control systems. According to Morck *et al.* (1998), in a pyramid ownership structure, a wealthy family controls assets worth vastly more than its investment by holding controlling interests in companies which hold controlling interests in other companies, and which in turn hold controlling interests in still more companies. In Korean conglomerates, the controlling families make use of control pyramid to expand the number of affiliates with only small amounts of their own capital. When we define the pyramid multiplier as the ratio of

[1] Kang *et al.* (1991) and Cho (1997).
[2] Kim (1999) and Shin (2000).

TABLE 1

SUMMARY STATISTICS ABOUT TOP 30 *CHAEBOLS*: 1987-97

	1987	1993	1994	1995	1996	1997
Ownership structure						
In-group shares	56.2	43.4	42.7	43.3	44.1	43.0
Controlling families	15.8	10.3	9.7	10.5	10.3	8.5
Cross-shareholding	40.4	33.1	33.1	32.8	33.8	34.5
Financial structure						
Equity-asset ratio		22.2	21.9	22.3	20.6	16.1
Debt-equity ratio		349.7	355.7	347.5	386.5	518.9
Cross-debt guarantee		469.8	258.1	161.9	107.3	92.2
Business structure						
# of subsidiaries	16.4	20.1	20.5	20.8	22.3	27.2
# of industries engaged		18.3 (31.2)	19.1 (30.4)	18.5 (29.6)	18.8 (29.6)	19.8 (30.0)
Total # of subsidiaries	509	604	616	623	669	819
Overall economic concentration						
Asset concentration		44.9	43.6	47.3	47.1	46.6
Value-added concentration		13.6	14.2	16.2	14.7	13.0

Notes: 1) The numbers in parenthesis are for the top 5 *chaebol*s.
2) Cross-debt guarantee is the ratio of the total amount of cross guarantee over equity capital.

the total amount of assets of a group to the controlling family's total investment, we find that the pyramid multiplier for the top 30 *chaebol* increased from 46.6 in 1989 to 88.2 in 1995 and to 183.3 in 1999.[3] The pyramid ownership structure can also explain the organizational difference between *chaebol* and Japanese business group.

Morck *et al.* (1998) criticized the pyramid control structure stating that this may exacerbate agency problems such as management entrenchment.[4] Moreover, the pyramid structure provides the controlling shareholder with the incentive to expand 'his' business group, because the expected risk of a new investment project tends to be under-evaluated while the expected benefit tends to be overvalued. These problems, without an appropriate monitoring mechanism, tend to encourage the building of a corporate empire. However, pyramid control may have some bene-

[3]For details of *chaebol*'s pyramid multiplier, see Hwang and Seo (2000).
[4]See Morck *et al.* (1998).

ficial effects depending upon the stage of economic development. At the early stages of economic development characterized by a lack of entrepreneurship and investment capital, pyramid control can contribute to the diffusion of entrepreneurship and the expansion of industrial foundation. The pyramid ownership structure, by protecting the management from the threat of hostile takeovers, also allows them to implement long-term strategies.[5] Given that there are both advantages and disadvantages, the existence of pyramid control *per se* does not imply the inappropriateness of the *chaebol* structure. In general, the effects of the control pyramid on *chaebol* performance will depend on the stage of economic development, market disciplining mechanisms, entrepreneurial capability, as well as other factors.

B. Controlling Shareholder-Managerialism

We characterize the *chaebol* governance structure as "controlling shareholder-managerialism," whereby a controlling family participates in the management of all the affiliates, and there is usually no effective management disciplining mechanisms in place.

Controlling shareholder-managerialism is different from shareholder capitalism and stakeholderism. Under the shareholderism, management is constrained to maximize the shareholder values, while the interests of employees and creditors as well as shareholders are treated as important under the stakeholderism. In contrast, controlling shareholder-managerialism in the Korean *chaebol* places the controlling shareholder's interest as utmost priority.

The *chaebol* has a controlling shareholder-centric, authoritative and hierarchical governance structure. The controlling shareholder, referred to as the chairman, controls the whole business group through the group headquarters, often referred to as the "Chairman's Office." It plays an important role in coordinating the internal resource allocation so as to economize market transaction costs. Nevertheless, the chairman's office serves as a steward of the chairman and his family, and by monopolizing all the important decision-making, usually surpasses the boards of directors of individual affiliates. The accounting system has fallen short of international standards, and so there has existed the informational

[5] See Khanna and Palepu (1998).

asymmetry between management and general investors.[6] As a result, the management of a *chaebol* tends to place priority on the chairman's interests before others.

From the theoretical perspective, this *chaebol* governance may magnify the agency problems and sometimes reduce the value of general investors. We should consider historical and institutional factors to understand how the controlling shareholder managerialsm with potential problems has sustained at least until the outbreak of the crisis in 1997. The problems in *chaebol* governance, if any, have multi-dimensional aspects including *chaebol*'s organizational structure, little protection of shareholders and dormant-shareholders, reluctant institutional investors, absence of takeover market, financial institutions as a tool of industrial policy, and competition policy and insolvency procedures overwhelmed by industrial policy. In the next section we show how these factors have contributed to the persistence of controlling shareholder-managerialism and how government policies have distorted the incentive structure of market participants.

III. Multi-Dimensional Aspects of Governance Problems

A. Internal Control System

a) Dominance by Controlling Shareholder

As we have already mentioned, the chairman controls 'his' business group through a chairman's office. The chairman's office is at the apex of the hierarchical organizational structure. It not only establishes group-related policies such as long-term goal, strategic financing, investment planning, but also intervenes into the individual affiliates' daily business. The chairman's office assumes the role of centralizing capital allocation decisions and also coordinates the business activities of each affiliate, treating the affiliate firm as a division of a single corporation. Since the chairman's office centralizes operating decision as well as strategic and financial decisions, the *chaebol*s should be classified as having a CM-form structure.[7]

[6]According to an ADB's survey in 1998, only 10 out of 81 surveyed listed companies followed international accounting standards, and 49% did not follow the international accounting standards at all.

TABLE 2

CHAIRMAN'S OFFICE IN KOREAN *CHAEBOL*

Chaebol	Year of establishment	Size as of 1994	Function
Samsung	1959. 9.	11 teams, 180	Assistance of chairman; Coordination, support and management of group affairs
Hyundai	1979. 1.	5 teams, 52	Control and coordination of affiliates' business planning
LG	1968. 1.	4 teams, 60	Control and support of affiliates' management; Evaluation of management performance; Coordination of planning
Daewoo	1976	8 teams, 86	Integration and coordination of group operation
SK	1974. 4.	5 division, 1 team, 117	Providing solutions to affiliates' management problems; Distribution of chairman's management policy

Source: Kim (2000) and Choi (2000)

The chairman's offices were established mainly because of the increasing needs for effective information processing as the number of affiliates and the scope of business expanded. Table 2 shows the year of establishment, function and size of the chairman's offices of the top 5 *chaebols*. In general they serve as a steward of the chairman and his family and at the same time, play the role of control tower for the internal capital market, even though their detailed functions are different depending on the historical stage of development and business portfolio of each *chaebol*.

b) Impotent Board of Directors

In a *chaebol*, the boards were usually under the chairman's control, and the chairman's office was assigned to monitoring the management of the whole business group. The boards did not monitor nor did they confront the management including the controlling shareholder in any sense because all of board members were usually inside directors appointed by the chairman. In

[7]The *chaebols* are not exactly an M-form corporation. The chairman's offices are deeply involved in the operating of their affiliates, while a typical M-form corporate structure is characterized by the separation of strategic and operating functions (*i.e.* operating decentralization).

addition, the lack of market disciplining mechanisms caused the directors and management to become insensitive to the voices from the general shareholders.

In a sense, the chairman acted as a director or a shadow director of all the affiliates. However, there were no explicitly defined responsibilities of 'shadow directors', and as such no official procedures to charge the chairman upon the event of management failure were established. Thus, we may say that the chairman as CEO is allowed to exercise plenary management discretion, and at the same time as a controlling shareholder was more often than not the only important player in monitoring and disciplining management of the whole business group.

C. Investor Protection and Incentive

a) Little Protection and Sleeping Shareholders

As explained above, there are agency problems between controlling family and general shareholders. But the general shareholder did not actively participated in monitoring management activities for the following reasons.

First, minority shareholders had no proper means to monitor and discipline the opportunistic behavior of the management. Historically, shareholder proposals were not allowed before 1997. In the case of a derivative suit, the minimum shareholding requirement was 1% before 1997, and the shareholder-plaintiff must offer collateral to the court and establish the damage to the firm before a case may be considered. Moreover, it was possible to make reconciliation between the shareholder-plaintiff and defendant halfway through the suit,[8] which then contradicts the purpose of derivative suits as a collective action suit. This resulted in the ineffectiveness of filing a suit and for example, the cumulative number of derivative suit was only 5 until 1996.

Second, the "Wall Street Rule" did not work. The effect of the "Wall Street Rule" presupposes management transparency and well-functioning M&A markets. However, only until very recently, the chairman's office and the controlling family monopolized management information, and virtually no market for corporate control existed in Korea.

[8]After revision of Commercial Code in December 1999, the reconciliation in the middle of suit became possible only through court mediation.

Third, besides these institutional limitations and the well-known free-rider problems among minority shareholders, the shareholders themselves in Korea had little interest in monitoring the management performance. Through frequent transactions, they pursued short-term capital gains in the stock market. According to the Securities Exchange Law, the minimum holding period required for shareholders that enables them to exercise important shareholder rights is 6 months. However, the individual investors in Korea did not hold shares for more than 3 months on average and as such could not make use of their shareholder rights (see Table 3).

Shareholders rarely participated in AGM(Annual General Meetings). During 1994-8, the ratio of participating shareholders in an AGM was a mere 2 to 5 %, while the amount of shares participating in an AGM was about 60 to 70% (see Tables 4). Proxy-fights have been rare implying that the main participants at AGMs are usually the relatively large shareholders. As a result, due to the indifference of minority shareholders to the corporate management, the AGM just became a formal procedure to meet legal requirement.

b) Reluctant Institutional Investors

Institutional investors, through their long-term relationships, can acquire better information about a firm and, by holding large amount of shares of a firm, can affect the firm's management in normal times. In terms of time and cost, the monitoring and restraining of a firm's management during normal times is better than litigation raised after the failure of management. For institutional investors to successfully monitor the invested firms, they should have good governance themselves.

In Korea, institutional investors did not function properly. First, institutional investors have taken low weights in stock market, their portion amounting to around 20% to 30% of total shares of listed companies.[9] In addition, considering that most of the non-bank financial companies belong to *chaebol*s, the weight of institutional investors independent of *chaebol*s will be much lowered.[10] Due to this low weight, institutional investors encounter little liquidity

[9]In the US, institutional investors hold more than 40% of total shares of listed companies, as from 1985. And the funds take over 20% of total shares of listed companies.

[10]On the other hand, the corporations through cross-investment hold more than 20% of total shares of listed companies

TABLE 3

TRANSACTION TURNOVER RATIO BY INVESTOR TYPE

Year	Banks	Insurance companies	Investment and trust co.	Securities co.	Other finance companies	Individual	Foreigner
1996	0.50	0.54	2.10	3.64	0.85	4.01	0.95
1997	0.41	0.35	6.76	4.45	1.43	5.37	1.84
1998	1.60	0.93	6.89	7.05	3.53	11.31	1.76

Notes: 1) Other finance companies include merchant banks and mutual savings and finance companies
2) Transaction turnover ratio = (sales + purchases)/number of shares end of year

Source: Stock, Korea Stock Exchange

TABLE 4

SHAREHOLDERS PARTICIPATING RATIOS IN AGM (%)

	1994	1995	1996	1997
NPS/TNS	2.90	5.32	2.69	2.31
NIP/TNS	1.82	2.41	1.76	1.07
NPP/TNS	1.08	2.91	0.93	1.24
NIP/NPS	62.80	45.34	65.50	46.35
NPP/NPS	37.19	54.66	34.50	53.65

Notes: TNS: Total Number of Shareholders
NPS: Number of Participated Shareholders
NIP: Number of In-person Participation
NPP: Number of Proxy Participation

Source: Chung and Sohn (1998)

problems, and consequently the free-rider problem of minority shareholders extends to institutional investors as well.

Second, there were various legal limits on the share of assets that financial institutions could invest (see Table 5). In addition, investment trust companies and trust accounts of commercial banks were required to follow shadow voting rules under which these institutions divided their votes in accordance with the accept/reject ratios of votes cast by other shareholders attending shareholder meetings. The financial institutions belonging to *chaebol* could not exercise their voting rights.[11] This restriction has two consequences. On the one hand, it prevents those institutions

TABLE 5

RESTRICTIONS ON FINANCIAL INSTITUTIONS' SHAREHOLDING AS OF 1997

	Ceiling to total investment	Ceiling to investment in identical firm
Bank		
Own account	100% of own capital	10% of shares of a firm
Trust account	25% of average remaining amount in last month	Same as above
Insurance company	30% of total assets	Same as above (for affiliates of top 30 *chaebol*, 5% of shares of an affiliate of other *chaebol*)
Securities company	65% of own capital (60% for listed companies, 5% for non-listed companies)	Minimum of 5% of shares of a firm and 6% of own capital
Investment trust company		
Own account	50% of own capital	5% of shares of a firm
Trust account	-	Minimum of 20% of shares of a firm and 10% of trusted assets

Source: Lee *et al.* (2000, p. 344)

from exercising voting rights favorable to their affiliated firms, and on the other hand, the controlling shareholder, by making use of 'his' financial institutions' maximum shareholding limits, can control the subsidiary firms with a relatively small amount of capital. Therefore, it can hardly be expected that institutional investors could monitor and restrain the invested firms' management, especially the *chaebol*.

Third, the role of public funds regarding to corporate governance was negligent. In US, various pension funds have actively participated in management discipline through relationship investing and initiated shareholder activism from 1980s. On the contrary, public funds in Korea cannot in principle purchase stocks by law unless stock purchasing complies to public interests as well as their operational purposes. In 1995, only the largest four funds (National Pension Corporation, Government Employees Pension Corporation, Korea Teachers Pension, and Insurance Supervisory Service Fund)

[11]Monopoly Regulation and Fair Trade Act, Article 11

invested in stocks, which occupy around 5.3% of total amount of shares of listed companies. The value of shares held by the largest three funds (National Pension Corporation, Government Employees Pension Corporation, Korea Teachers Pension) constituted a mere 1.2% of total value of shares of listed companies in 1999. And the value of bonds held by these funds amounted to about 5% of total transaction value of bonds.

In addition to this low position in capital market, the fiduciary management of public funds has the incentive structure distorted by the government intervention. The government has traditionally utilized the funds as a tool to accomplish various policy targets rather than to meet the interest of fund members. As such public funds have severe problems in procedural transparency and governance on their own. For example, public funds are classified as Special Accounts in the National Accounts and as such Congress could not monitor them. The government's utilization of public funds as a policy tool together with their poor governance diminished the fund manager's incentive to satisfy the members' interests, which implies that public funds had little incentive to monitor the invested firms' management behavior.

c) Absence of Market for Corporate Control

With the absence of internal management disciplining mechanisms, the market for corporate control plays a critical role in shaping good governance. In Korea, however, there has been virtually no takeover market because of the peculiarities of the *chaebol* ownership structure and other factors protecting the incumbent management.

The pyramid ownership structure and cross-shareholding among the subsidiaries protected incumbent management from takeover threats. In addition, the government has also maintained policies against M&A, because the government believed that M&As could be a channel for *chaebol*s to expand their business scope and thus increase their concentration of economic power. The Securities Exchange Law until the revision of 1997, had put a restriction on the individual's maximum amount of shareholding to 10%. And the potential acquirer of a firm having more than 25% share must acquire more than 50% share through tender-offer. For foreign investors, there were restrictions on their amount of shareholding and the size of firms they were permitted to acquire. Institutional investors under government control and with their small amount of shareholding could not become a potential threat to the incumbent management.

All of these contributed to the reduction of the cost for the controlling shareholder in maintaining his position.[12] During 1994-7, there were 13 hostile takeover attempts, more than half of which failed due to white knights, greenmail and other tactics used by the incumbent management.[13]

C. Financial Institutions: Tools for Industrial Policy

Financial institutions as creditors can exercise their repossession rights in the case of default, based upon which they can influence the management decisions of debtor firms. In addition, since institutional investors, by having long-term relationships with debtors, can acquire better information about management performance compared to individual shareholders, and thus, can affect management performance in normal times.

In Korea, banks usually had great potential to discipline the management of debtor firms. Capital markets have been premature and banks were the main source of corporate financing during economic growth in Korea. In fact, bank lending occupies 47.6% of GDP in 1997 while the *chaebol*'s debt/equity ratio was over 350%, which was high compared to 166.5% in US, 209.6% in Japan, and 87.2% in Taiwan (See Table 6). However, government intervention into bank operation and lending practices gave the banks no incentive to behave as management discipliner.

First, the government utilized banks as a tool to implement industrial policies. It intervened into a bank's operation including the increase in a bank's capital, appointment and dismissal of CEOs, establishment of branches, determination of rates of interest and commission, development of financial commodities, and even everyday lending operation. In addition, the government has recapitalized non-viable banks, which generated moral hazard problems in bank operation. As a result, serious governance problems have persisted in financial intermediaries.

Second, most of the lending were accompanied by collateral and

[12] Hwang (2000a)
[13] Zhuang *et al.* (2000)

TABLE 6

DEBT/EQUITY RATIOS OF *CHAEBOL*

Size of *chaebol*	1994	1995	1996	1997	1998
Top 1 - 5	308.6	298.3	349.0	472.5	331.9
6 - 10	383.2	370.6	436.4	639.2	382.0
11 - 30	479.3	503.9	464.2	621.5	488.4
1 - 30	354.8	348.8	387.1	521.5	362.6

Source: Choi (2000)

guarantees of other (affiliate) firms, which made the pattern of bank lending to be based on the debtor firm's size of asset. Moreover, the legal protection level of creditors is high in Korea compared to other industrialized countries.[14] As a result, the capability of banks to control financial risks has remained underdeveloped. They increasingly lost whatever ability they had to discriminate between competent and incompetent firms (and projects), and had little incentive to monitor the performance of borrowing firms.

D. Policies for Too-Big-To-Fail Legacy

Product market competition, by forcing the firm to minimize costs, induces corporations to improve their governance structure. Product market competition alone cannot solve all problems of corporate governance, but it is one of the most powerful means toward economic efficiency. For some reason, as will be explained below, product market competition in Korea has not played its effective role.

First, the government promoted the 'too-big-to-fail' legacy through its interventionist industrial policies in the last three decades. The government selected industries and corporations to be supported, and adopted financial, tax and trade policies for those corporations. Furthermore, it directly intervened into the process of industrial and corporate restructuring. The government-led corporate and industrial restructuring from the late 1970s mainly resulted in the transfer of incompetent subsidiary of a *chaebol* to another *chaebol*,

[14]According to La Porta *et al.* (1997), the index of creditor protection, ranging 0 to 4, is 0 in France, 1 in US, 2 in Japan and Taiwan, 3 in Korea and Germany, 4 in UK.

which was justified on the grounds that this minimized the social costs incurred from large firm bankruptcy.[15] Consequently, the 'too big to fail' legacy became more or less a practical rule.

Second, by establishing entry barriers and price regulations, the government protected the incumbent firms rather than promoted market competition. Some studies reveal that the government operated entry and price regulations in a wide range of industries.[16]

Third, the ineffective bankruptcy systems effected another exit barrier. Legal proceedings were inefficient, as well as time-consuming and expensive. For example, the average period of court receivership from application to termination of the process was 9 years (see Table 7). Also, no separate bankruptcy court existed, legal expertise lacked, and judges had too much room for discretion in the proceedings. The comparison of ongoing values and liquidation values was introduced as an economic criterion in court receivership procedure only after the outbreak of the recent economic crisis.

IV. *Chaebol* Structure and Performance: An Empirical Study

A. Regression Model

In the Korean conglomerates, the controlling families use the pyramid leverage to control assets worth much more than their own investment, and outside investors have not any effective means to discipline the behavior of management nor the controlling families. As such, the controlling shareholders have an immense degree of freedom in managing the entire business group usually for their own interest. From the theoretical perspective, controlling shareholder managerialism may magnify agency problems and reduce the public shareholder value (Morck *et al.* 1998). According to Ghemawat and Khanna (1998), however, it may have beneficial effects on corporate performance and allocative efficiency, depending on the stage of economic development and the institutional infrastructure for market transaction. As we have already emphasized, the existence of the pyramid control *per se* does not necessarily imply the suboptimality of the *chaebol* structure, and its

[15]This type of restructuring also applies to the financial sector.
[16]See Hwang (1998) and Kim (1994).

TABLE 7

TIME SPENT IN COURT RECEIVERSHIP (YEAR)

	Application - beginning		Beginning - approval		Approval -termination/ Abolition		Total	
	TF	AF	TF	AF	TF	AF	TF	AF
Average	0.50	0.60	1.15	1.77	7.78	6.69	9.30	6.54
Min.	0.14	0.08	0.37	0.35	1.21	0.92	3.77	1.17
Max.	1.52	1.64	11.44	4.24	15.36	16.12	17.19	17.04

Note: TF: Terminated firms, AF: Abolished firms
Source: Kang (2000)

implication on performance also depends on the historical phase of each *chaebol* and entrepreneurial capability.

In this section we perform a regression analysis to examine how the *chaebol*'s ownership and governance structure affects the group performance. In order to capture the controlling shareholder managerialism, we use the pyramid multiplier (PYRAMID) as the proxy variable for the *chaebol* governance structure. We measure the pyramid multiplier as the ratio of total amount of assets of each *chaebol* to that of in-group share which is the sum of the controlling family's shareholdings and cross-shareholdings between affiliates.[17] This reflects the degree of potential agency problems between the controlling family and the general investors including the creditors as well as the outside shareholders.

Agency theory argues that corporate performance also depends on the distribution of residual claims (Jensen and Meckling 1976). Following this arguments, previous literature has used the ownership concentration indices to capture the potential conflicts of interest between management and shareholders (Demsetz and Lehn 1985; and Morck, Shleifer, and Vishny 1988). Because the agency problems in *chaebol*s arise from the conflict of interests between the controlling family and the general investors, the ownership structure of the residual claims alone does not fully reflect the *chaebol*-specific governance problems. Nevertheless we add the in-group share (SHARE) to the model as a proxy for ownership

[17]We also experiment using an alternative definition: the ratio of total assets over the controlling family's shareholdings. But this variable was found to have high correlation with other control variables.

concentration and examine whether the traditional arguments of agency theory (SHARE) is valid in *chaebol* structure.

Many factors other than ownership and governance structure will affect the level of performance such as the market structure, debt structure, business portfolio strategy, and so on. Thus we need to control for these variables in investigating the effects of ownership and governance structure on business performance. The control variables in this study include each *chaebol*'s weighted market share (WMS_i), advertisement intensity (WAD_i), debt-equity ratio ($DEBTEQ_i$), relative size of assets ($RelSIZE_i$), sales per employee ($WORK_i$). We use the Entropy diversification index (DT_i) and the related diversification ratio ($DRDT_i$)[18] to control for the effects of business structure and management strategy on performance. In addition, the model includes the interactive term of PYRAMID and DT ($DTPY_i$) to examine the marginal effect of each variable. Specifically, we estimate the following regression model.

$$Performance_i = F(WMS_i,\ WAD_i,\ DEBTEQ_i,\ RelSIZE_i,\ WORK_i,\ DT_i,\ DRDT_i,\ PYRAMID_i,\ SHARE_i,\ DTPY_i)$$

B. Methods and Results

We estimate the above model by using the ordinary least square (OLS) method for the pooled data of the top 30 *chaebol*s during 1993-96.[19] This period lies between the inauguration of President Kim Young-Sam in 1993 and the dark cloud of the recent financial crisis.[20] Taking these facts into consideration, this empirical study aims at testing whether the pyramid control was indeed a factor that worsened *chaebol*s' performance in the pre-crisis period. Since the implications of the pyramid control on performance may be different from period to period, we also regress the same model with the data of the top 30 for 1989-92.

Corporate performance can be measured in various ways, and the regression results may differ depending on which performance

[18]DRDT is defined by the percentage ratio of related diversification over total diversification.

[19]Kia, whose managers were not the controlling shareholder, is excluded from the data set.

[20]The seven *chaebol*s among the top 30 went into bankruptcy in 1997, starting from Hanbo on January 23.

measures are used. In order to minimize this discrepancy, we adopt return on assets (ROA), returns on invested capital (ROIC), and operational income on total sales (OITS) as dependent variable and proceed with an empirical study for each variable.[21] However, we find that the sign and statistical implication of the estimated coefficients of the key variables do not depend on the choice of performance measures. Thus without loss of generality, we focus on explaining the empirical results on the model using ROA as a dependent variable, which is summarized in Table 8.

From the regression results, we find three interesting points about the effects of ownership and governance structure on *chaebol* performance. First, there exists a reverse U-shaped relationship between the pyramid multiplier and performance. We see this from model 6-8 in Table 8, in which the square term of the pyramid multiplier has been included. The estimated coefficient of the multiplier has a positive sign while the square term has a negative sign, and both of two variables are statistically significant. This statistical finding implies that the performance improves as the multiplier increases to some critical point, but the multiplier starts to deteriorate performance after that point. This relationship is also valid for the different sample period of 1989-92.

Second, the control multiplier negatively affected *chaebol* performance during 1993-6. This can be seen from various models 1-5 in Table 8, in which most of the estimated coefficients of the multiplier have a negative sign with statistical significance. More interestingly, we find the opposite case for the sample period of 1989-92.[22] Thus it is highly likely that the *chaebol*'s pyramid control structure became to reveal its limitations around the early 1990s. A question may arise as to why this reversal occurred. One possible explanation is because the pyramid multiplier increased beyond the optimal scope that could be efficiently controlled by the controlling family. Perhaps, another alternative or complementary reason might be because the optimal scope also decreased as the results of rapid change of business surroundings. Since 1993, for example, the Kim Young-Sam administration had initiated deregu

[21]ROA is defined as the percentage ratio of profits over gross asset. OITS is the ratio of operational incomes over sales, and ROIC is the ratio of sum of profit and financial cost over the sum of total capital and long-term debt.
[22]Hwang (2000a) explains, as one plausible explanation, the beneficial effects of pyramid control by entrepreneur capability and founding culture.

TABLE 8

REGRESSION RESULTS (1993-6)

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Constant	0.0199	-0.8044	-1.4488	-2.1506*	-1.2012	-2.5624**	-2.6899	-3.8775***
	(0.018)	(-0.921)	(-1.231)	(-1.945)	(-1.123)	(-2.157)	(-2.514)	(-2.993)
WMS	0.0100	0.0121	0.0151	-0.0040	0.0036	-0.0039	-0.0041	0.0148
	(0.500)	(0.694)	(0.817)	(-0.214)	(0.204)	(-0.175)	(-0.206)	(0.844)
ADI	-0.3479	-1.009***		-1.3085***	-1.2305***	-0.9241**	-0.7814**	
	(-1.157)	(-3.129)		(-3.798)	(-3.741)	(-2.342)	(-2.186)	
DEBTEQ		-0.0013***	-0.0012***		-0.0011***		-0.0012***	-0.0011***
		(-3.434)	(-3.059)		(-2.868)		(-3.322)	(-2.856)
RelSIZE						0.3559	0.3489	
						(1.653)	(1.807)	
WORK			0.0016			-0.0004	-0.0006	0.0007
			(1.193)			(-0.263)	(-0.444)	(0.583)
DT		1.4324***	0.3903	0.9029*	1.0715**	0.9104*	0.8784*	0.1239
		(3.419)	(0.956)	(1.981)	(2.489)	(1.841)	(1.975)	(0.315)
DRDT		0.0273**	0.0258**	0.0387***	0.0317***	0.0329***	0.0256**	0.0219**
		(2.568)	(2.374)	(3.539)	(3.040)	(2.924)	(2.504)	(2.114)
PYRAMID	-0.0475**	-0.0312	-0.0393*	-0.0645***	-0.0451**	0.1106*	0.1492***	0.1430***
	(-2.248)	(-1.571)	(-1.855)	(-3.297)	(-2.248)	(1.932)	(2.882)	(2.665)
$PYRAMID^2$						-0.0023***	-0.0025***	-0.0025***
						(-3.104)	(-3.710)	(-3.660)
DTPY			0.0024*	0.0044***	0.0037***			0.0024*
			(1.896)	(3.336)	(2.943)			(1.950)
SHARE	4.5403**		2.0376	4.2824**	1.5774			3.3147*
	(2.347)		(1.056)	(2.382)	(0.875)			(1.696)
DUMMY	-4.6841***	-0.6970	-1.003	-3.5511***	-0.9530	-2.9043***	-0.4141	-1.0188
	(-7.487)	(-0.858)	(-1.024)	(-5.863)	(-1.035)	(-5.520)	(-0.536)	(-1.104)
Adjusted R^2	40.8	48.0	45.3	52.0	51.2	50.0	53.4	51.2
F-Value	16.9	15.9	11.4	16.6	14.2	13.8	14.0	12.8
# of obser-vations	116	114	114	116	114	116	114	114

Notes: 1) The numbers in the parentheses represent t-value
2) ***, **, * means statistical significance at the level of 1%, 5%, and 10%, respectively.
3) Dummy = 1 if the group is bankrupt as of April 1998.

lation and market liberalization in expectation of the launch of the WTO in 1995 and on Korea's joining the OECD in 1996. As a result, the rivalry among firms became intensified, and the problems inherent to the controlling family-centric governance structure manifested themselves. The findings here that the pyramid control structure decreased *chaebol* performance may imply that *chaebol*s should have changed their internal control system to improve managerial efficiency before they faced the financial crisis in 1997. They also provide a clue to understanding why people started to demand *chaebol* governance reform in 1995.

Third, in most cases, the variable SHARE had a positive effect on performance. In other words, as the management's ownership increases, the potential conflict of interests between management and shareholders decreases, and thus the group performance improves. This result is not strange because so far many empirical studies have not shown a negative relationship between management ownership and corporate value. But the findings here are interesting because the government has maintained a hostile approach to ownership concentration and cross-equity investments among affiliates.

V. Governance Reform and Evaluation

A. Governance Reform[23]

Since the crisis, *chaebol*s have been pinpointed as the culprits of the Korean economy's structural weakness and have undergone severe pressure to restructure themselves. Moreover, the new D. J. Kim government presented five principles for *chaebol* reform in January 1998.[24] These are enhanced transparency, strengthening accountability, resolution of cross-debt guarantees, improvement of financial structure, and streamlining business activities. The reform of corporate governance is an essential part of the *chaebol* reform policy. A good number of measures directed to *chaebol* governance were introduced by revising laws and making new regulations. These aimed particularly at reducing the controlling shareholder's influence, improving the management transparency, strengthening the roles of the board of directors, enhancing the minority shareholder legal rights and protection.

Those measures as regards the board system include (i) requiring the listed companies to appoint outside directors and to set up an audit committee where outside directors dominate; (ii) introducing

[23]For details of corporate governance reform, see the Appendix.

[24]On August 1999, the government added three further principles for *chaebol* reform including prohibition of (i) circular equity investment among affiliates, (ii) unfair trading among affiliates, and (iii) unlawful bequests.

director's duty of loyalty in Commercial Code; (iii) delineating the responsibility of shadow directors; and (iv) inducing *chaebol* to abolish chairman's offices. The shareholder's rights have been strengthened: The cumulative voting system was introduced to amplify the voices of minority shareholders in electing board members. Shareholder proposal rights were also introduced. The minimum requirement for shareholders to exercise various shareholder rights was lowered. For example, the shareholder with 0.01% of share can raise a derivative suit. Also, shadow voting by institutional investors has been repealed.

As regards management transparency, legal changes have been made so that domestic auditing practices conform to international standards. The top 30 *chaebol*s are required to compile combined financial statements comprising all the affiliates regardless of their equity holdings as from the beginning of 1999. In addition, for the top 10 *chaebol*s, large internal transactions must get board approval and be disclosed to the public. To activate the market for corporate control, the various restrictions on hostile takeovers have been eliminated: The ceilings on equity ownership by domestic and foreign investors and the restraints on firm size in foreign investor's takeover have also been eliminated. The mandatory purchase of stocks in takeover has been repealed.

The bankruptcy system also experienced changes. The comparison of ongoing values and liquidating values of the applicant firm was introduced as an economic criterion in the court receivership procedure in April 1998. Time limits on each stage of court receivership procedure have been shortened. Also, the court receivership and bankruptcy process became linked so that the dropout firms in court receivership will be directly sent to file for bankruptcy.

B. Evaluation

It is still too early to evaluate the effectiveness of the reforms on corporate governance structure. The reform of corporate governance has until now been concerned only with changing formal institutions. However, we should bear in mind that "it is in the end the law that is written in the hearts of the people that counts" (Riker 1976, p. 13). Since informal constraints have more inertia than formal institutions, the consistent and clear enforcement of reforms is much more important than the mere introduction of new rules.

Moreover, debates about further reforms of formal institutions as relates corporate governance is still under progress. In this section, we will describe the characteristics of the reform and evaluate only whether the direction of reform efforts is appropriate.

First, the reform proceeded at an abnormal situation in which there was much antipathy towards the *chaebol*: A number of chairmen of *chaebol*s, implicated in the political corruption scandal, were sentenced to imprisonment in 1995 and also several *chaebol*s went bankrupt one after the other in 1997. These events only fueled the antipathy toward the *chaebol* and its chairmen. Also, the government started policy-oriented discussions on corporate governance in 1995. However, before the characteristics and problems of Korean corporate governance structure were thoroughly examined, the economic crisis arrived and the government hastily introduced measures that were not yet fully understood. As such, the policy measures were potentially inadequate to remedy the problems in the Korean economy.

Second, the government reform policy put too much restriction on internal control systems. For example, government required the large enterprises to have an outside director-dominated board composition, and also forced the top 30 *chaebol*s to abolish group head offices. We should bear in mind that *chaebol* governance is a multi-dimensional issue as examined in Section III. In the developed countries, the focus of discussion about corporate governance is on internal control system after usually assuming that market disciplining mechanisms including stock and debt market, takeover market, and product market are functioning properly. But those market infrastructure disciplining the corporate management have not been well established in Korea. The major problems of *chaebol* governance largely come from the lack of market disciplining mechanisms. Thus, the government should put more efforts in providing the appropriate environments where market mechanisms operate effectively. And since there is no such single and universal model for the internal governance structure that variety should be encouraged, the government should set up minimal guidelines on the internal control system rather than enforcing a specific structure.

In addition, the court's inability to make reliable economic judgements also resulted in some of the weaknesses of current governance structure. If the courts do not function properly then the strengthening of shareholder's right may generate unreasonable judgements and will also cause much delay in the procedures. Hence, the mere shortening of the court receivership procedure will make the procedure more inefficient.[25]

VI. Discussion and Conclusion

We have characterized the *chaebol* governance as controlling shareholder-managerialism, differentiating it from shareholder capitalism and stakeholderism. We showed the multi-dimensional aspects of the *chaebol* governance problems. By regression analysis, we found that the *chaebol* governance should have been improved even before the crisis. However, we explained why the necessity of improvement of *chaebol* governance could not justify the way in which the government has initiated the governance reform since the crisis.

There are more fundamental issues in discussing about the Korean corporate governance structure that needs to be considered. First, it should be recognized that the governance problems in Korea are closely related to interventionist government policies as well as to the absence of corporations' initiative to change their own governance structure. As is well known, market competition as a discovery process is the most efficient force to shape the firms' optimal structure. It is therefore better to allow markets to discipline corporations than for the government to enforce a change in the internal governance structure. Korea as well as most Asian countries lacks market disciplining mechanisms. So the concept of corporate governance, which is usually confined to the internal control system as in the OECD Corporate Governance Guidelines, should more focus on the market disciplining mechanisms in Asian countries. In other words, the government should present the minimum guidelines about the internal governance so that the optimal structure, which varies across firms and over time, can evolve from competition among organizations.

A further point is that the proper incentive structure in which the market participants including shareholders voluntarily and actively participate in monitoring and disciplining management

[25]For the details, see Seo (2000).

should be established. Recently, foreign investors' share in the capital market and the general shareholders' interests in corporate control have increased. However, institutional investors including banks and public funds still lack sound governance structures. It is thus important to first establish good governance in institutional investors for shareholder activism to diffuse over the economy.

A final point is that when considering the public perception of a firm, it may be about time to discuss whether the objective of the firm's management should be restricted solely to maximize shareholder values. The first objective of the firm may be the maximization of shareholder values, which is considered to be a global standard. However, in Korea, the firm is considered as a public entity that has social responsibilities.[26] Given this wide-spread perception in Korea, grafting Anglo-American shareholderism *per se* may exacerbate the conflict of interests among stakeholders. Cultural value is a constraint to the management of firms and should not be neglected when understanding the social role of a firm. It is thus necessary to figure out how to harmonize the growth of firms, together with shareholder value and other cultural values.

[26]According to a survey, 51.4% of general respondents put the welfare of employees and social responsibility as the first objective of management, while 86.5% of professional respondents put the development of firm and shareholder's interests as the first objective of management.

	Share holder value	Welfare of employees	Social benefit	Growth and development of firm
General respondents	3.1	20.0	31.4	45.5
Professional respondents	28.5	1.0	12.5	58.0

Source: Hwang *et al.* (1999)

Appendix: Corporate Governance Reform in Korea as of 2000

Board of Directors	
Duty of Loyalty	Commercial Code
Shadow Director's Responsibility	Commercial Code
Audit Committee	Commercial Code: more than or equal to 2/3 of members must be outside directors
Mandatory Introduction of Outside Directors	Securities Exchange Law
Shareholder Rights (requirements in Securities and Exchange Law)	
Derivative Suit	1% (0.5%) → 0.05% → 0.01%
Claim right of dismissal of directors, auditors and liquidator	1% (0.5%) → 0.5% (0.25%)
Cumulative voting	
Claim right to peruse accounting records	3% (1.5%) → 1% (0.5%)
Claim right to inspect the business matters and the state of assets	3% (1.5%)
Claim right to call GM	3% (1.5%) → 1% (0.5%)
Documentary voting allowed	
Shareholder proposal right	1% (0.5%)
M&A Regulation	
Elimination of mandatory purchase of stocks	Securities Exchange Law
Foreigners' takeover of domestic firms	Foreign Investment Promotion Act • not allowed only for defense industry • alleviation of requirement for board approval
Institutional Investors	
Abolition of shadow voting	Securities and Investment Trust Business Law
Provision of disclosure process for voting	Enforcement Rules of Securities and Investment Trust Business Law
Improvement of Large Securities companies's governance structure	Securities Exchange Law • Number of Outside directors: at least three and more than or equal to 1/2 board members. • Mandatory establishment of audit committee • Strengthening the requirement for exercising shareholder's rights
Announcement and reporting to Financial Supervisory Service of dishonest disclosure	Disclosure Rules on Exercising Voting Rights of Securities and Investment Trust companies

(Table continue)

Accounting System	
Combined Financial Statements	Enforcement Ordinance on Outside Auditing of corporations
Action suit against outside auditor	Same as above
Penalty on unreliable auditing	Same as above
Measures for Corporate Restructuring	
Simplifying M&A process	• Introduction of small scale merger • Wide application of short-form merger (continuing firm's share of exterminating firms: 100% → 90%) • Shortening the period during which creditors can submit objection: 2 months → 1 month
Bankruptcy System	
Court Receivership Procedure	• Introduction of comparison of ongoing value and liquidating value as an economic criterion • Promoting speedy procedure: shortening of periods for decision on stay, and on beginning of procedure • Shortening of payment grace period, alleviating requirement for reorganization plan. allowing creditors to request abolition of procedure. • Establishment of administration committee, introduction of court's right to request necessary data when application is submitted, establishment of creditors council • Dropout firms in court receivership are directly sent to bankruptcy process
Bankruptcy Procedure	Linked with court receivership procedure

Notes: 1) Securities and Exchange Law requires the shareholding period more than or equal to 6 months.
2) The numbers inside of ( ) are applied to the firms whose capital is more than or equal to 100 billion Korean Won.

Sources: Korea Securities Research Institute (1999) and Seo (2000).

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