

WHO WILL CONTROL *FRANKENSTEIN*? THE KOREAN *CHAEBOL*'S CORPORATE GOVERNANCE

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ABSTRACT

In a *chaebol*, because a dominant family exercises control with only a small equity-holding, a sharp disparity exists between cash-flow rights and voting rights. The controller reduces managerial agency costs but creates his own agency costs. Furthermore, the disparity exacerbates the controller's agency costs. Outsider shareholders' voting rights are ineffectual in eradicating this problem. Therefore, external monitoring devices over the *chaebol* controller are required.

Korea has relied on government regulation—including attempts to change *chaebols*' ownership structures—to address this problem. Unfortunately, without well-functioning capital markets, the regulation has proved ineffective. As observed in the *SK* scandal, a market for corporate control could be helpful in policing the *chaebol* controller's mismanagement or tunneling. In this changing environment, regulators should focus on facilitating capital markets and monitoring interested party transactions in the *chaebol* instead of attempting to change the *chaebols*' ownership structure.

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INTRODUCTION

Korean *chaebols*¹—family-controlled business conglomerates—have been described as “*Frankenstein* companies that are dangerous if left unsupervised yet near-impossible to control.”² As illustrated in Table 1, the Korean economy has been described as a *chaebol*-driven or *chaebol*-centered system.³ In 2002, *chaebols* were involved in an average of 19.2 industries,⁴ ranging “from chips to

¹ The definition of the *chaebol* is still debatable. In general, to call an entity a “chaebol,” three requirements should be met: it must be (1) a conglomerate, (2) family controlled and (3) have a substantial proportion in the national economy. JEONG-PYO CHOI, THE THEORY AND THE REALITY OF THE KOREAN *CHAEBOL* 6-7 (2004). Meanwhile, *Dokjeom Gyuje Mit Gongjeong Georae Gwanhan Beobryul* [Monopoly Regulation and Fair Trade Act] [hereinafter, MRFTA] uses the term “enterprise group,” instead of the term *chaebol*, which is defined as a group of companies whose businesses are substantially controlled by an individual or a company (MRFTA, art. 2 (2)). Indeed, most Korean *chaebols* belong to the enterprise group.

² *South Korea: Freeing Finance*, THE ECONOMIST (London), June 3, 1995, at survey 15.

³ OK-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korean Chaebol*, 34 LAW & POL'Y INT'L BUS. 183, 184 (2002).

⁴ THE FAIR TRADE COMMISSION OF KOREA, 2003 ANNUAL REPORT ON FAIR TRADE 236 (2003).

ships.”⁵ In addition, public firms belonging to ten major *chaebols* accounted for more than 52% of stock market capitalization as of 2003.⁶

TABLE 1: CHAEBOLS’ CONTRIBUTION TO THE KOREAN NATIONAL ECONOMY⁷

Year	Value added		Sales		Assets	
	Top 5 <i>chaebols</i>	Top 30 <i>chaebols</i>	Top 5 <i>chaebols</i>	Top 30 <i>chaebols</i>	Top 5 <i>chaebols</i>	Top 30 <i>chaebols</i>
1992	7.63%	13.53%	28.91%	44.32%	24.91%	44.96%
1997	8.48%	13.05%	32.29%	45.85%	29.22%	46.25%

Source: Hong, *infra* note 91, at 24.

In spite of their significant contribution to the Korean national economy, *chaebols* have created many problems⁸ which encompass, for example, economic concentration,⁹ market dominance, authoritarian leadership, corruption, and threats to democracy. The corporate governance of the *chaebol* has been recently highlighted. One article in the literature states the general characteristics of the governance system in Korea as follows:

⁵ The *Hyundai chaebol* once used “from chips to ships” as its advertisement slogan.

⁶ See *infra* Table 6 in Part III.

⁷ At the same time, the trend of *chaebols’* bipolarization is also remarkable. That is, the contribution of large *chaebols* to the national economy is increasing, whereas that of small *chaebols* is decreasing.

⁸ However, it is noteworthy that the evaluation of the *chaebol* fluctuated according to economic cycles. “When the Korean economy performs well, the *chaebol* is praised as the engine of rapid economic growth; however, when the economy faces a crisis, the *chaebol* becomes a main cause of the crisis.” Not only Koreans but also international institutions and foreign scholars react in the same way. See SEUNG-MIN YOO, *THE CHAEBOL, IS IT THE MAIN CAUSE OF A CRISIS?* 35-36 (2000).

⁹ *Chaebols’* economic concentration and diversification are substantial. However, as illustrated in the table below, such level of concentration and diversification is also observed in other countries. See DAE-HONG CHANG ET AL., *THE EFFICIENCY OF THE CHAEBOL* 29 (2001).

INTERNATIONAL COMPARISON OF ECONOMIC CONCENTRATION (THE 30 LARGEST COMPANIES, AS OF 1993)

	Employment	Sales	Assets
Korea (30 <i>chaebols</i>)	18.5%	42.5%	46.5%
The U.S.	22.9%	34.6%	22.4%
Japan	15.0%	25.8%	22.7%
Germany	31.7%	38.8%	22.7%
The U.K.	32.6%	48.6%	29.5%

Most Korean corporations are owned and managed by a principal shareholder . . . Many Korean corporations belong to a conglomerate business group . . . These *chaebols* are predominantly managed by the principal owners Decisions at the top tend to be made by owners . . . especially strategic and financial decisions [tend to be] in the hands of a single individual or family The owner-manager . . . is believed [to be] . . . enhancing “responsible management” and . . . reducing the agency problem between the owner and management. [T]here exists [an] . . . interest conflict or agency problem between the controlling shareholders and minority outside shareholders.¹⁰

Indeed, the reckless management of the *chaebols* is regarded as a primary contributor to the financial crisis.¹¹ Therefore, when Korea requested a bailout from the International Monetary Fund (“IMF”) and the World Bank, both institutions required that Korea improve its corporate governance structure in order to receive loans.¹² In addition to this international pressure, public shareholders—primarily domestic watchdog groups and foreign institutional investors—have pushed *chaebol* firms to improve their corporate governance structure.

Under these circumstances, the ownership structure of the *chaebol* is the center of debate. In a typical Korean *chaebol*, the dominant family usually owns only a small equity share in the con-

¹⁰ Young-Ki Lee & Young-Jae Lim, *In Search of Korea's New Corporate Governance System*, in AN AGENDA FOR ECONOMIC REFORM IN KOREA 155, 174 (Kenneth L. Judd & Young-Ki Lee eds., 2000). But note that the *chaebol* phenomenon is not peculiar to Korea. The *chaebol* is one “picture of the family-dominated firm, typical for emerging economies, in which control rents are likely to be high.” See Kenneth Scott, *Institutions of Corporate Governance: Implications of Korea*, in AN AGENDA FOR ECONOMIC REFORM IN KOREA 187, 197 (Kenneth L. Judd & Young-Ki Lee eds., 2000). Therefore, Korea's experience of the *chaebol* could be applied to other emerging economies confronting a similar problem.

¹¹ However, Yoo claims that the economic crisis was primarily caused by the negligence of the Korean government not by the *chaebols'* mismanagement. According to him, the government stuck with a past “development paradigm,” and failed to find its new role model in a rapidly changing economic circumstance. Therefore, restructuring only the *chaebol* does not address the problems which caused the economic crisis. See Yoo, *supra* note 8, at 34-42.

¹² For example, the IMF requested that the Korean *chaebols* disclose corporate information and make public their combined financial statements; in addition, it demanded reduction in the debt level of Korean companies and changes to the system of mutual guarantees within conglomerates. See SEA-JIN CHANG, FINANCIAL CRISIS AND TRANSFORMATION OF KOREAN BUSINESS GROUPS: THE RISE AND FALL OF CHAEBOLS 190 (2003). The IMF and the World Bank's response to the 1997-1998 East Asian financial crisis plainly revealed their preference for diffuse ownership. See Ronald Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Taxonomy* 7 (Stanford Law School Working Paper, October 2004) (on file with the author).

glomerate—less than 10% of the total equity in many cases. Surprisingly, however, the controller exercises control over virtually all affiliates. An interlocking web of shareholding among affiliates enables the dominant family to effectively control the entire conglomerate. Accordingly, the *chaebol* system presents the radical separation of cash-flow rights (ownership) and voting rights (control).

Chaebol reformers and the Fair Trade Commission of Korea (“KFTC”) claim that the current ownership structure of the *chaebol*—in particular, the sharp gap between cash-flow rights and voting rights—tends to generate a strong incentive for the dominant shareholder to extract private benefits at the expense of public shareholders.¹³ Song’s statement represents this view:

Most of the social costs associated with the *chaebol* will be derived from [a controlling minority] structure . . . Therefore, the corporate governance research and reform agenda . . . should focus on the question of how we can replace the [controlling minority] structure.¹⁴

Indeed, *chaebol*-related scandals in which a controller with a tiny equity share wastes or misappropriates corporate assets appear to support this argument.

On the contrary, a recent empirical study presents the fact that the disparity between cash-flow rights and voting rights in Korean firms does not have a direct relationship to corporate performance.¹⁵ Furthermore, the potential dissipation of corporate wealth cannot explain the surging popularity of at least some *chaebol* firms among investors. For example, Samsung Electronics, a core company of the Samsung *chaebol*, accounts for 18.18% of capitalization in the Korean stock market as of March 2005.¹⁶

¹³ See, e.g. Song, *supra* note 3; THE FAIR TRADE COMMISSION OF KOREA, A REPORT ON THE REFORM OF CORPORATE GOVERNANCE OF ENTERPRISE GROUPS (2004).

¹⁴ Song, *supra* note 3, at 244-45.

¹⁵ THE SAMSUNG ECONOMIC RESEARCH INSTITUTE, RESEARCH ON THE DISPARITY BETWEEN OWNERSHIP AND CONTROL AND CORPORATE PERFORMANCE (2004).

¹⁶ Furthermore, the foreign investors, who are generally skeptical about the *chaebol* system, reached 40.1% of the capitalization in the Korean stock market as of 2004. Korea Stock and Future Exchange, Statistics (April 25, 2005) available at http://krx.co.kr/webkor/tongInfo/sm/sm_01.jsp. With regard to foreign investment in public *chaebol* firms, see *infra* Part III, Table 6.

This note begins with questions as to whether a perfect ownership structure can exist. The collapses of *Daewoo*¹⁷ and *Hanbo*¹⁸ present the worst cases of the *chaebol* system. The failure of *Kia*,¹⁹ like the Enron scandal in the U.S., is the worst example of the failure of a Berle-Means corporation.²⁰ At the same time, none of the Korean firms with a controlling majority shareholder have developed into global enterprises.

These instances might be idiosyncratic, but they still imply that none of the ownership structures are perfect. At the same time, we learn from these cases that different ownership structures generate their own problems. It follows that the goal of *chaebol* policy should be to address the problems resulting from the *chaebol* system rather than to alter the ownership structure.

In this article I seek to identify the agency cost problems²¹ that the *chaebol* system generates and then provide some policy recommendations to address these problems. In so doing, I will also evaluate the current government regulation of the *chaebol*. This effort proceeds in a number of steps.

The analysis begins with a description of the *chaebol's* ownership structure. The dominant family of the *chaebol* owns only a small equity share. However, with help of intra-group shareholding, the family can effectively control the entire conglomerate. Coupled with legal rules that prohibit hostile takeovers, this ownership structure enables the family to run the *chaebol* virtually free from limitations or interference.

¹⁷ In 1999, *Daewoo*, then the second largest *chaebol* in Korea, went bankrupt. See *infra* Part II, C, 1.

¹⁸ The failed *Hanbo chaebol*, which had had no experience in the steel industry, began building an iron works, only depending on a huge amount of debt—5.7 trillion won (equivalent to \$5.7 billion) as of 1997. *Hanbo* could access bank loans by bribing high-profile politicians, who maintained a strong influence on the banks. See HAN-GOO LEE, *THE KOREAN CHAEBOL HISTORY* 627-32 (2004).

¹⁹ The failed *Kia*, the eighth largest conglomerate in 1997, was once regarded as an alternative to the *chaebol* system. The company was widely-held by fragmented investors and, absent a controlling shareholder, it was run by professional managers. For details, see *infra* Part II, B.

²⁰ The Berle-Means corporation is a company with diffused equity ownership among a multitude of small stockholders and a self-perpetuating management firmly in control.

²¹ Agency cost theory deals with the inevitable divergence of self-interest between a principal and an agent. In the corporate governance context, agency costs loom large in the relationship between managers and shareholders, or between controlling shareholders and non-controlling shareholders.

The second step in the analysis, building on findings about the *chaebol's* ownership structure, explores complex dynamics within the *chaebol*. The principal-agent problem in the *chaebol* has two different aspects: (1) agency problems that arise between managers—mostly, professional managers—and all shareholders; and (2) agency problems that arise between controlling and non-controlling shareholders. The *chaebol's* owners suffer from the first type of agency costs, and at the same time, they cause the second type of agency costs to the non-controlling outsiders. Furthermore, the sharp disparity between cash-flow rights and voting rights may aggravate the controlling shareholder's agency cost problem.²²

The non-controlling outside shareholders suffer both types of agency costs. As a result, the non-controlling shareholders are most vulnerable to the agency problems arising from the *chaebol*. In terms of *chaebols'* corporate governance, the protection of the non-controlling shareholders is particularly important. Many scholars indicate a positive relationship between capital market development and minority shareholder protection.²³

In fact, the public shareholders of *chaebol* firms face a trade-off between the agency problems of professional managers and those of its owner.²⁴ In many cases, it has been observed that the *chaebol* structure might be useful in reducing managerial agency costs. For example, *chaebol* firms might be run by competent professional managers who are vigorously monitored by the control-

²² However, the relationship between insider ownership and corporate value is still debatable. The convergence-of-interest hypothesis indicates that as insider ownership increases, agency costs may be reduced since managers bear a larger share of these costs. See, e.g., Michael C. Jensen and William H. Meckling, *Theory of Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). However, the managerial entrenchment hypothesis contends that increasing insider ownership insulates owner-managers from external disciplines such as hostile takeovers, reducing firm value. For example, McConnell and Servaes found a significant curvilinear relationship between Tobin's Q and the fraction of common stock owned by corporate insiders. That is, "[t]he curve slopes upward until insider ownership reaches approximately 40% to 50% and then slopes slightly downward." See John J. McConnell & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595 (1990).

²³ The story is somewhat straightforward. When a block-holder extracts value from minority stockholders, the prospective minority shareholder does not pay pro rata value for the stock. If the discount is deep enough, no one would want to sell stocks and, therefore, stock markets do not develop. See, e.g., Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

²⁴ Gilson terms it as "the controlling shareholder tradeoff." See Gilson, *supra* note 12, at 10.

ling stockholders. At the same time, the *chaebol* system is vulnerable to the nepotism of the so-called “owner” or “chairman,” i.e., the controlling shareholder. *Chaebol* firms might be run by family-managers who are not only incompetent but also interested in stealing corporate assets, i.e. tunneling.²⁵ Therefore, if a controlling shareholder diligently supervises professional managers and refrains from extracting private benefits, the *chaebol* system (putting aside economic concentration or other political concerns) may be desirable.

Conversely, the *chaebol* system rarely provides a check on the controlling block. That is, the *chaebol* structure is vulnerable to the expropriation of outside shareholders. By retaining control over all affiliate companies with the help of an interlocking web of shareholders, the dominant shareholder often extracts private benefits at the expense of the non-controlling shareholders. There are many monitoring devices in corporate law, such as independent directors and class-action lawsuits, that are geared toward lowering conventional agency costs—i.e., the agency problems arising between managers and stockholders as a whole. However, monitoring of the controlling shareholder extracting control rents is not yet adequately established. Therefore, in terms of the *chaebols*’ governance, external monitoring mechanisms over the controlling block become important. The question then turns on who will monitor the controlling shareholder.

The third step in the analysis examines the current devices used to monitor the *chaebols*’ dominant shareholders. Conventionally, the Korean government has played an important role in monitoring the owner-manager of the *chaebol*. In fact, regulators set a ceiling on intra-group shareholding as a preventive measure. Reducing the disparity between cash-flow rights and voting rights serves the function of curbing the controlling shareholder’s incentives to divert corporate value for private benefit.

Unfortunately, the experience of nearly two decades of *chaebol* regulation only provides evidence of “government failure.” Despite regulation, the disparity between cash-flow rights and voting rights has increased. More importantly, this regulation has gen-

²⁵ The term “tunneling” is used to describe the transfer of assets and profits out of firms for the benefit of those who control them. See Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000).

erated unnecessary inefficiencies by narrowing the realm of business activities.

The final step in the analysis seeks alternative monitoring mechanisms to government regulation. Since the Asian financial crisis, the economic environment surrounding the *chaebol* has changed dramatically. Most of all, the *chaebol* is now exposed to market discipline, proxy contests, and even hostile takeovers. Indeed, the *SK* scandal, discussed below, offers an example of how a family acting in bad faith might suffer an attack from the market.

Because of their small equity share, the potential threat of hostile takeovers increases the private cost of control for which the *chaebol* family must pay. The dominant family has two options²⁶ to prevent takeovers: (1) they can work diligently to raise firm value, or (2) they can increase block-holding. The former makes the *chaebol* system more efficient, while the latter would moderate the problems caused by the sharp disparity between cash-flow rights and voting rights.

In the current environment, where the market has begun to play a meaningful role in disciplining *chaebols*, the role of regulators should change. The body of experience that is available—particularly for developed economies—implies that direct regulations aimed at addressing mismanagement are rarely effective. Rather, this task could be achieved by other means, such as well-functioning capital markets, product markets, professional norms, and so forth. In this regard, regulators need to take one step back from existing *chaebol* regulations. They should assist other institutions, such as stock markets or banks, in functioning well. In particular, the government should not curb the development of an embryonic market for corporate control.

Meanwhile, strong corporate law could reduce unfair wealth transfer from firms to insiders. Therefore, regulators should focus on interested party transactions. For example, the fiduciary duty of the controlling shareholder needs to be clearly articulated. Specifying a procedure for self-dealing will reduce inappropriate value diversion. If internal and external monitoring mechanisms over the dominant shareholders are well-devised, the existence of the

²⁶ Of course, one can imagine a new option, in which the *chaebol* or other groups lobby to make hostile takeovers impossible or difficult. Indeed, *chaebols* currently play a key role in such political campaigns. Furthermore, these campaigns are largely based on nationalism, because many potential bidders are foreign investors. But this new political option is beyond the scope of this article. I will investigate this issue in subsequent research.

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controlling shareholders—even if they hold only small stakes—may reduce agency costs as a whole and ultimately benefit public shareholders.

Part I explores the ownership structure of the *chaebol*. This section presents the way in which the *chaebol* controller can dominate all subsidiaries despite having only a small equity-holding. Part I also analyzes the political and legal background that allowed for the creation of *chaebol* ownership.

Part II deals with agency problems in the *chaebol* system. The *chaebol* system generates two sets of agency problems: (1) the agency problem between professional managers and shareholders as a whole; and (2) the agency problem between controlling shareholders and non-controlling shareholders. The most important consideration, in terms of agency cost analysis, is how to protect outside shareholders from a dominant shareholder's arbitrary decisions.

Part III discusses the effectiveness of the current regulation of the *chaebol*—in particular, the effectiveness of attempts to reduce the disparity between control and ownership by curbing intra-group shareholding. Evidence suggests that this regulation has been ineffective at reducing the disparity.

Part IV argues that *chaebol* policy should be redirected. Instead of the dominant role of government agencies, the capital market should play a more central role in reducing agency costs. Indeed, capital markets seem to have begun disciplining controlling shareholders acting in bad faith. In addition to the active capital markets, more attention should be paid to interested party transactions.

Finally, Part V summarizes my argument.

I. THE CONTROLLING MINORITY STRUCTURE

Chaebol firms are connected through an interlocking web of shareholders. The leadership or charisma of the founding family reinforces the close relationship among the affiliated companies. However, the stocks of listed *chaebol* firms are relatively well-dispersed among the public.

Specifically, the dominant family usually holds a small fraction of the equity claims on *chaebol* companies' cash flows. In other words, one of the minority stockholders, i.e., the dominant family, controls the entire *chaebol*. In this sense, the *chaebol's* ownership

falls into the category of a controlling minority structure (“CM structure”), as opposed to a concentrated ownership structure (“CO structure”), or a dispersed ownership structure (“DO structure”). In this section, I will present a stylized ownership pattern of the *chaebol* and offer an explanation as to how such an ownership structure has been developed.

A. *General Features of the Chaebol's Ownership Structure*

The *chaebol* is usually comprised of numerous independent legal entities. It has developed a typical ownership structure, which depends primarily on stock-pyramiding and circular-ownership, to allow the controller to influence all subsidiaries. The development of the *chaebol* was largely affected by legal rules prohibiting takeovers.

1. *The small equity shares of the chaebol family*

One of the unique characteristics of the *chaebol's* ownership structure is the sharp disparity between cash-flow rights and voting rights. For instance, a typical dominant family holds less than 10% of a *chaebol's* stock. Nevertheless, it effectively retains control over all subsidiaries. The secret of its leveraged voting rights lies in intra-group shareholding, which often amounts to nearly 45% of the *chaebol's* equity; pyramiding and circular-ownership are used to connect numerous member firms under the control of *chaebol* families.

As a matter of fact, Table 2 indicates that the dominant family of the ten largest enterprise groups effectively exercises control, holding only an average of 4% of the stocks of all affiliate companies. Moreover, the controlling family's share tends to be smaller in major *chaebols* than in minor *chaebols*. The complicated ownership structure among affiliates allows them to exert voting power equal to nearly 45% of total stocks.

TABLE 2: THE EQUITY OWNERSHIP OF THE TEN LARGEST ENTERPRISE GROUPS IN 2004

Family	Inside equity shares		Outside equity shares
	Intra-group holding	Subtotal	
4%	40.8%	44.8%	55.2%

Source: The Fair Trade Commission of Korea.

This complicated ownership structure often makes it difficult for researchers to delineate the *chaebol* in ownership patterns. For example, Samsung Electronics, one of the Samsung *chaebol's* core companies, belongs to widely-held firms with a 20% cutoff and, at the same time, family-controlled firms with a 10% cutoff. Additionally, it is in a pyramid. Rafael La Porta explains:

Samsung's Lee Kun-Hee [heir-controller] controls 8.3 percent of Samsung Electronics directly. But he also controls 15 percent of Samsung Life, which controls 8.7 percent of Samsung Electronics, as well as 14.1 percent of *Cheil Jedang*, which controls 3.2 percent of Samsung Electronics directly but also 11.5 percent of Samsung Life. Lee Kun-Hee has additional indirect stakes in Samsung Electronics as well. Because there are no 20 percent ownership chains, we call Samsung Electronics widely held on the 20 percent definition. But because between his direct holdings and holdings in Samsung Life Lee Kun-Hee controls over 10 percent of the votes in Samsung Electronics, it is a family-controlled firm on the 10 percent definition. It is also controlled through a pyramid.²⁷

To illustrate this point more clearly, let me introduce a hypothetical, but fairly typical, *chaebol*—say, *Hanguok*.²⁸ The *Hanguok chaebol* is comprised of eight companies with total assets of 400 billion won (equivalent to \$400 million).²⁹ Assume that Companies A, B and C, which are indicated in bold characters, are listed on the stock market; therefore, 30% equity ownership should be enough to provide a shareholder with de facto control of these three companies.³⁰

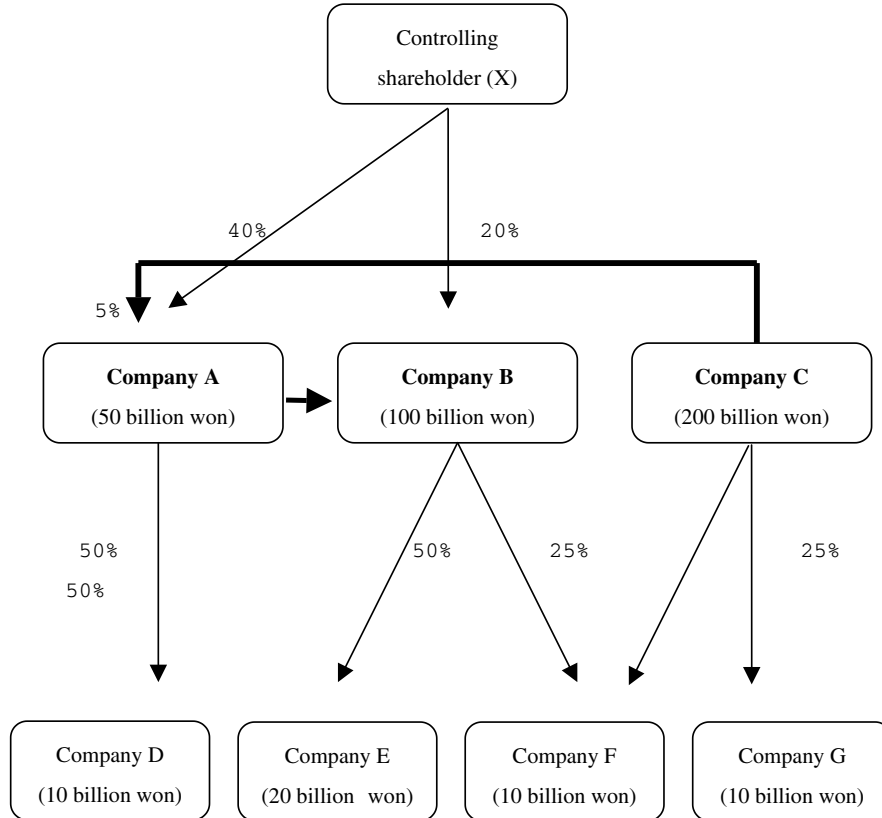
²⁷ Rafael La Porta et al., *Corporate Ownership around the World*, 54 J. FIN. 471, 482-83 (1999). The authors rely on data from 1984. Data from 1997 shows that although the Lee family and other affiliated companies held 21.9% of the equity in Samsung Electronics, other aspects of its ownership structure did not change substantially. See JIN-BANG KIM, *THE OWNERSHIP AND CONTROL OF THE KOREAN CHAEBOL: 1997-2002*, 20 (Working Paper, 2003) (on file with the Seoul Institute of Economic and Social Studies).

²⁸ This stylized *chaebol's* ownership structure is based on empirical studies. See, e.g., Dong-Won Kim, *Interlocking Ownership in the Korean Chaebol*, 11 CORP. GOVERNANCE 132 (2003) (analyzing the ownership structure of the *Doosan chaebol*); CHANG, *supra* note 12; Kim, *supra* note 29.

²⁹ The won is the unit of currency used in Korea. As of March 2005, 1,000 won was equivalent to approximately one dollar.

³⁰ This assumption is made only to simplify the analysis.

FIGURE 1: THE OWNERSHIP STRUCTURE OF THE HANGOOK *CHAEBOL*³¹



In Figure 1, the dominant family holds 40% of Company A's stocks and 20% of Company B's stock; thus, the family's investment in the Hangeok *chaebol* is equivalent to 40 billion won (equivalent to \$40 million).³² In other words, the dominant family contributes only 10%³³ of the total investment in the Hangeok *chaebol*. Likewise, intra-group shareholding accounts for 97.5 billion won (equivalent to \$97.5 million) in assets,³⁴ which is, in turn,

³¹ Bold arrows among Companies A, B and C present circular-ownership.

³² This number is calculated as follows: 40% (X's share in Company A) x 50 billion won (Company A's assets) + 20% (X' share in Company B) x 100 billion won (Company B's assets).

³³ 40 billion won out of 400 billion won.

³⁴ This number is calculated as follows: 5% (Company C's share in Company A) x 50 billion won (Company A's assets) + 10% (Company A's share in Company B) x 100 billion won (Company B's assets) + 30% (Company B's share in Company C) x 200 billion won (Company C's assets) + 50% (Company A's share in Company D) x 10 billion won (Com-

equivalent to 24.4%³⁵ of the total investment. The remaining 65.6%³⁶ of the total investment comes from outside shareholders.

In Figure 1, despite a relatively small equity, the dominant shareholder, X, is able to effectively control the entire business conglomerate. When intra-group holding is added to the dominant shareholder's equity shares, X exercises enough voting rights to dominate the boards of all subsidiaries. For example, the controlling owner holds only 20% of Company B's stock, which is not sufficient to dominate the company on its own.³⁷ Nevertheless, the controlling owner effectively controls Company B, due to the 10% equity shares owned by Company A, which, in turn, is under the control of X. The combination of 20% direct equity shares and 10% indirect equity shares enables the controlling shareholder to exercise 30% of Company B's voting rights, which is initially assumed to be enough to dominate the firm. Similarly, the family can exert control over Company C without even owning its shares because Company B, which is under the control of X, holds 30% of Company C.

2. *The disparity between cash-flow rights and voting rights*

As with the hypothetical Hangoon *chaebol* in Figure 1, most Korean *chaebols* are controlled by a dominant family holding a minority of the stock. In this sense, the *chaebol's* ownership falls into the category of a CM structure. The CM structure, which generates a sharp gap between cash-flow rights and voting rights, is generally achieved in three different ways: dual class stocks, stock pyramids, and cross-ownership.³⁸ Two other categories of ownership, which are compared to the CM structure, are a DO structure and CO structure. Firms with widely-dispersed stockholders be-

pany D's assets) + 50% (Company B's share in Company E) x 20 billion won (Company E's assets) + 25% (Company B's share in Company F) x 10 billion won (Company F's assets) + 25% (Company C's share in Company F) x 10 billion won (Company F's assets) + 25% (Company C's share in Company F) x 10 billion won (Company G's assets).

³⁵ 97.5 billion won out of 400 billion won.

³⁶ This share is calculated by deducting the X's equity share (10%) and intra-group shareholding (24.4%) from the entire equity.

³⁷ Note that a shareholder is assumed to need 30% of the equity to effectively control Companies A, B and C.

³⁸ Lucian Arye Bebchuck et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295 (Randall Morck ed., 2000).

long to the DO structure, whereas firms with a controlling majority shareholder belong to the CO structure.

The CM structure resembles the CO structure to the extent that it insulates controllers from removal and the DO structure to the extent that it places corporate control with an insider who has a small equity share.³⁹ However, unlike CO structures, in which controlling shareholders internalize most of the value effects of their decisions through their shareholdings, minority controllers can shift losses resulting from their wrongdoing to outside shareholders.⁴⁰ Moreover, the CM structure lacks the principal mechanisms that limit agency costs in other ownership structures. Unlike DO structures, in which controlling management faces threats of removal—for example, proxy contests or hostile takeovers—the controllers of the CM structure are virtually protected from such threats.

With regard to lacking threats of removal, it is noteworthy that entrenched control might be preserved by either the ownership structure itself or other factors, such as legal rules. Dual class stocks represent an example of the former. When a company issues dual class stocks and a controller can exercise super-majority voting power, proxy contests or hostile takeovers are practically impossible; therefore, the controller can maintain control as long as he wants. Meanwhile, in the case of a *chaebol*, the dominant family is able to preserve its control partially due to the legal rules. For instance, until 1994, the Security Exchange Act prohibited outsiders from holding more than 10% of a listed company. Once this restriction was lifted, many *chaebol* firms have been exposed to the threat of proxy contests or even hostile takeovers.⁴¹

To indicate the disparity between cash-flow rights and voting rights, the KFTC uses two measures: the disparity rate (“DR”) and the voting right multiplier (“VRM”). These measures are used to establish a graduated standard for the restrictions on intra-group shareholding, which we shall explore more thoroughly in Part III.

The DR refers to the difference between voting rights and cash-flow rights, whereas the VRM refers to the voting rights divided by the cash-flow rights. Figure 1 illustrates this point: when Company B dissolves, the dominant shareholder X can request 24

³⁹ *Id.*

⁴⁰ *Infra* Part II.

⁴¹ *Infra* Part IV.

billion won: first, 20 billion won will be distributed to X for his 20% equity in Company B; then, 10 billion won will be distributed to Company A for its 10% equity in Company B; finally, of these 10 billion won, X can additionally request 4 billion won for his 40% equity in Company A. Therefore, X can eventually retain 24 billion won, which means that his cash-flow rights are equivalent to 24%,⁴² while he, in fact, exercises 30% of the voting rights. In this case, the DR becomes 6% (30% - 24%); meanwhile, the VRM becomes 1.25 (30% / 24%).

Similarly, while X's voting rights in Company C are 30%, his cash-flow rights are 7.2%.⁴³ Sixty billion won will be distributed to Company B for its 30% equity in Company C; therefore, X can eventually retain 14.4 billion won through companies B and A.⁴⁴ As a result, the DR of Company C becomes 22.8% (30% - 7.2%) and the VRM 4.17 (30% / 7.2%).

Briefly, the controlling shareholder tends to internalize the harm he causes to the firms less, as his cash-flow rights become smaller. Therefore, in firms with a higher DR or VRM, controlling owners are more likely to divert value for their private benefit at the expense of public shareholders. In Figure 1, the controlling shareholder dominates Companies B and C, respectively, with 30% of the voting rights; however, Company C is more susceptible to the expropriation of outside shareholders. All else equal, X only bears 7.2% of the loss that Company C suffers; whereas X must bear 24% of the loss that Company B suffers. Therefore, X has more incentive to extract his private benefit from Company C than from Company B.

B. *The Development of the Chaebol's Ownership Structure*

The development of *chaebols'* CM structures appears to be substantially influenced by industrial policies and legal rules. Throughout its development, the *chaebol* has tended to diversify business. It is still debatable whether the *chaebol's* diversification was the result of efficiency-enhancing or rent-seeking activities. Nevertheless, in launching a new venture, the *chaebol* consistently

⁴² 24 billion won out of 100 billion won.

⁴³ 14.4 billion won out of 200 billion won.

⁴⁴ Note that, as calculated above, X's cash-flow rights in Company B are 24%. Consequently, out of 60 billion won, which dissolved Company C distributed to Company B, X can request 14.4 billion won (24% x 60 billion won).

established legally independent subsidiaries rather than divisions within the existing company.

Meanwhile, the government pushed *chaebol* firms to go public. This ownership diffusion policy was implemented to ease widespread anti-*chaebol* sentiment. In so doing, regulators eliminated the possibility of hostile takeovers. Alternative methods—such as dual class stocks or cross-ownership—which the founding family often uses to preserve its control, are prohibited in Korea. For these reasons, most *chaebols* built a stock pyramid and employed an interlocking web of shareholding to maintain the family's control.

In the remainder of this part, I will explore the development of CM structures from three main perspectives: diversification, ownership diffusion policy, and legal barriers to alternative methods of establishing the CM structure.

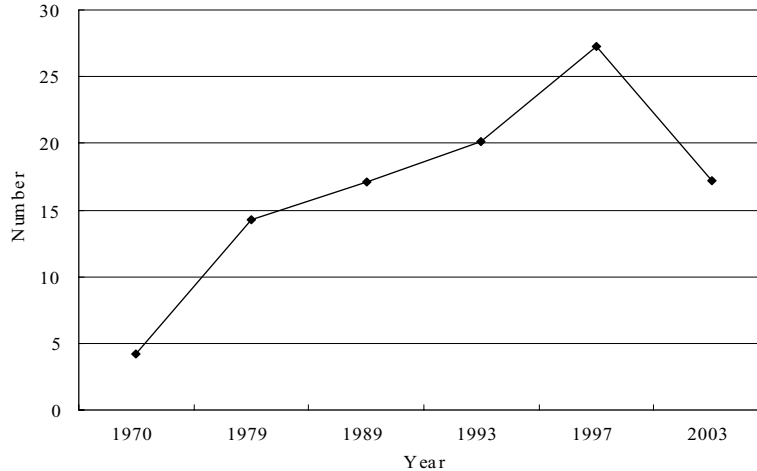
1. *Diversification*

The *chaebol* is comprised of numerous subsidiaries. As seen in Figure 2, the controlling shareholder of the *chaebol* eagerly pursued diversification until circumstances dramatically changed as a result of the economic crisis in 1997.⁴⁵ For example, thirty major enterprise groups initially held an average of four affiliates in 1970. Thereafter, the average number of affiliates increased sharply, reaching 27.3 in 1997. This trend has changed however since 1997; for instance, in 2003, forty-nine major enterprise groups held an average of 17.2 subsidiaries.⁴⁶

⁴⁵ For a detailed description of the *chaebol's* diversification, see CHANG, *supra* note 12, at 79-109.

⁴⁶ There are two possible explanations for the reduction since the late 1990s: bankruptcy and inheritance. First, during the economic crisis, some major *chaebols* holding a large number of affiliates collapsed. For example, the *Daewoo chaebol*, with forty-one subsidiaries in 1999, went bankrupt and was eventually dismantled. Besides *Daewoo*, other *chaebols* such as *Hanbo*, *Jinro*, *Woosung* and *Haitai* consecutively failed during this period.

Second, for inheritance purposes, some *chaebols* split themselves into smaller units. The *Hyundai chaebol* is a good example. After Joo-Young Chung, the founder of the *Hyundai chaebol* died in 2001, his heirs divided the conglomerate into three smaller yet still significant ones; *Hyundai Motor*, *Hyundai Heavy Industry* and *Hyundai*. Not as dramatic as *Hyundai*, the Lee family of the *Samsung chaebol* was also separated into *Samsung*, *Shinsege*, *CJ* and *Hansol*, all of which place their name in the top 49 enterprise groups in 2003.

FIGURE 2: THE AVERAGE NUMBER OF SUBSIDIARIES⁴⁷

Source: CHANG, *supra* note 12; THE FAIR TRADE COMMISSION OF KOREA, *infra* note 75.

With respect to *chaebols'* diversification, two points are noteworthy. First, although some *chaebols* hold up to fifty to sixty subsidiaries, in many cases, sales are concentrated in a few core subsidiaries.⁴⁸ For example, in the case of four major *chaebols*, sales of the four largest member companies, between 1988 and 1995, accounted for an average of 79% of total sales. Specifically, in the case of the Samsung *chaebol*, which held fifty-five subsidiaries as of 1995, sales of the four largest member companies reached 90% of the *chaebol's* total sales.⁴⁹

Second, *chaebols* generally carried out both unrelated (horizontal) and related (vertical) diversification. Once a *chaebol* entered into an unrelated industry, it sought to expand to vertically-

⁴⁸ The numbers from 1970 through 1997 were gathered from thirty enterprise groups—including most *chaebols*—whereas the number in 2003 is from forty-nine enterprise groups. The discrepancy in numbers is due to the fact that the MRFTA was amended in 2002. Prior to the amendment, the KFTC supervised thirty enterprise groups sorted by asset ranking; however, under the amended MRFTA of 2002, enterprise groups with assets of more than 2 trillion won (equivalent to \$ 2 billion) are subject to regulation, such as restrictions on debt guarantees (MRFTA Art. 8-3) and the prohibition of cross-ownership (MRFTA Art. 9). The number of enterprise groups meeting the threshold were forty-nine as of 2003.

⁴⁹ Ha-Joon Jang & Heung-Jae Park, *A Search for an Alternative Policy Regarding the Korean Large Firms*, in DOES THE KOREAN CHAEBOL HAVE A FUTURE? 431, 461 (The Korea Economic Research Institute ed., 2000).

related industries to consolidate the previous business.⁵⁰ For example, the LG *chaebol*, which already produced cosmetics, jumped into the chemical industry to acquire high quality plastic containers for its cosmetics.⁵¹ Likewise, the Hyundai *chaebol*, which engaged in construction and shipbuilding, entered into furniture and paint production.⁵²

Until the late 1990s, the Korean government regarded diversification as a problematic aspect of *chaebols*. For instance, during 1994-1997, regulators enforced a so-called “specialization” policy.⁵³ Under this policy, if *chaebols* specialized in two or three core industries, they were exempt from financial restrictions imposed on them. “Big deals”—business exchanges among *chaebols* primarily driven by the Dae-Jung Kim Administration during the economic crisis—stemmed from the idea that *chaebols*’ excessive diversification caused social inefficiency.

However, it is still debatable whether *chaebols*’ diversification was socially inefficient. With respect to factors driving *chaebols* to diversify, researchers provide various explanations. For example, Khanna and Palepu⁵⁴ argue that group affiliation of the *chaebol* enhanced efficiency and, therefore, was beneficial to the economy. Accordingly, in the emerging economies, many institutions which are taken for granted in developed economies are missing. These institutions include competent managers or efficient capital markets. Internal markets created by group affiliation substitute for these missing institutions in the emerging economies.

Conversely, many researchers claim that such diversification was closely related to rent-seeking activities.⁵⁵ For example, Chung-Hee Park, the leader of a military coup in 1961, wanted to compensate for his illegitimacy through an economic development

⁵⁰ *Id.*

⁵¹ *See id.*, at 461-466.

⁵² SEUNG-HOON LEE, *Chaebols and Multi-National Corporations: Two Models of Economic Development* 130 (2004).

⁵³ *Id.*

⁵⁴ However, like many other *chaebol* regulations, this “specialization” policy is now thought to be a failure. As a matter of fact, despite this policy, the Samsung *chaebol* jumped into the car manufacturing business, which ended up being a financial disaster for the entire conglomerate. For a critical view of this regulation, see Yoo, *supra* note 8, at 109-22.

⁵⁵ *See, e.g.*, Tarun Khanna & Krishna Palepu, *The Right Way to Restructure Conglomerates in Emerging Markets*, HARV. BUS. REV. Jul.-Aug. 1999, at 125; Tarun Khanna, *Business Groups and Social Welfare in Emerging Markets: Existing Evidence and Unanswered Questions*, 44 EUR. ECON. REV. 748 (2000).

program. With private capital exceedingly scarce, President Park adopted a growth strategy, based on the “selection and concentration” of industries. Under these economic development plans, the government virtually superseded free markets and administered resource allocations itself. This government-driven economic policy produced a large amount of rents, which were generated by entry barriers and differential of interest rates. Accordingly, diversification based on the establishment of many subsidiaries was advantageous to collecting these rents.

Between 1960 and 1970, the military regime enacted laws to promote entrepreneurial participation in selected industries by guaranteeing monopolistic profits and erecting entry barriers. Since this type of legislation included somewhat analogous provisions, the Machinery Industry Promotion Act, which was enacted in 1967 and repealed in 1986, is an instructive example. This law provided that entrepreneurs should ‘register’ to do business in the machinery industry (Art. 6). Once permitted, the entrepreneurs were obligated to ‘report’ business affairs to the Secretary of Commerce and Industry (Art. 16). In addition, the Secretary could ‘order’ the entrepreneurs to replace, restructure, and systematize their facilities (Art. 8).

Besides entry barriers, financial support—particularly, cheaper loans—was extensively used to attract businessmen. The government allocated a so-called “policy loan,” i.e. preferred loan, to entrepreneurs participating in selected industries at a much lower rate than usual. As a result, selected firms were able to finance at a rate of 5.6 - 7.1%, while the average interest rate was usually 25 - 30%.⁵⁶

To facilitate the allocation of loans to the preferred industrial sectors, the government took control of the banking industry. It nationalized major commercial banks in 1962. As a result, banks, to the extent they complied with the government order, were not concerned about factors such as the borrowers’ ability to repay a loan or the profitability of their business. Instead, the lenders superficially checked the firm’s size—more specifically, its assets—and often requested co-signers. In this situation, expansion through diversification even into unrelated industries appeared to

⁵⁶ See, e.g., CHEOL-GYU KANG, *THE ECONOMICS OF CHAEBOL REFORM* (1999); Ji-Sang Jang, *The Chaebol and International Competitiveness* (1994) (Working Paper) (on file with the Seoul Institute of Economic and Social Studies).

be lucrative; a new subsidiary meant a new financial source for the *chaebol* because of its increased size and more potential co-signers.

Moreover, the preferential support resulted in huge economic advantages to the selected entrepreneurs, whose businesses were usually converted into *chaebols*. The participants in the target industries were often selected based on their relationships with politicians or government officials. Therefore, once entrepreneurs had succeeded in one area, they were better able to participate in other new 'pet' industries because of their existing relationships with politicians as well as their past credibility.⁵⁷

2. *Ownership diffusion policy*

As the founders of the *chaebol* accumulated wealth in the 1960 and 1970s, anti-*chaebol* public sentiment surged. The unfair allocation of business opportunities, monopolistic positions, and other special treatment given to the *chaebol* founders, combined with publicized bribery or corruption scandals, led many Koreans to believe that the *chaebols'* wealth was illegitimate. Since the military regime supported the *chaebol* both directly and indirectly, the anti-*chaebol* sentiments became a burden on the government.

As a result, the government attempted to alleviate growing concerns about economic concentration by implementing an ownership diffusion policy. In 1968, the legislature passed the Law on Fostering Capital Market, which was designed to facilitate initial public offering ("IPO") and thus diffuse stocks among individuals. A few incentives were given to firms going public. For instance, the law provided that listed corporations were subject to lower corporate tax rates than unlisted ones (Art. 9). Still, many entrepreneurs were unwilling to take their firms public, fearing loss of control.

Subsequently, the IPO Facilitation Act of 1972 provided that the Minister of Finance could give an 'order' to the corporation to go public, which was regarded as having met predetermined conditions. A "carrot and stick" approach was used to spur IPOs. For example, if the corporation followed the order, it benefited from preferential tax treatment. On the other hand, if the corporation failed to comply with the order, it suffered severe tax penalties.⁵⁸

⁵⁷ CHANG, *supra* note 12, at 51.

⁵⁸ In addition, Jang & Park argue that diversification is often used for *chaebol* families' inheritance. See Jang & Park, *supra* note 48, at 462.

Under this law, in 1974, the Minister of Finance selected fifty-four firms and ordered them to go public. However, these firms were hesitant.⁵⁹ Indeed, most firms relied heavily on bank loans, which were often subsidized by the government. Therefore, the equity market had little advantage to entrepreneurs. In addition, many owner-managers preferred to remain private because they were worried about other shareholders' participation in the management. By early 1975, forty-eight firms had ultimately gone public, but many core *chaebol* firms remained privately-held.⁶⁰

To ease the founder's fear of hostile takeovers, the Security Exchange Act was amended in 1976 to prohibit investors other than initial owners from retaining more than 10% of a firm's equity. As a result, the *chaebol* family was virtually immune from hostile takeovers until 1994, when the restriction was abolished. This measure facilitated ownership diffusion in firms belonging to the *chaebol*. For example, 309 large corporations completed IPOs in 1979.⁶¹ Consequently, the protective measure in the former Security Exchange Act allowed the *chaebol* family to retain control over all subsidiaries with a small equity share.

3. *Legal barriers to alternative methods*

The *chaebol's* controlling minority structure has been facilitated primarily by diversification and the ownership diffusion policy. In addition, legal restrictions on stock ownership have also contributed to shaping current ownership structures by restricting other options to establishing the CM structure. To be sure, the CM structure, which generates a sharp gap between cash-flow rights and voting rights, is generally achieved in three different ways: dual class stocks, stock pyramids and cross-ownership.⁶²

As mentioned above, the CM structure of the *chaebol* is a hybrid of pyramids and circular-ownership. The reason the *chaebol* family has chosen such a complicated ownership structure is closely linked to the restriction on dual class stocks, cross-ownership, and holding companies. For instance, in Korea, dual class stocks are

⁵⁹ In addition, listing on the first tier of the stock exchange requires that over 40% of stock be held by shareholders owning less than 1%, and that the principal owner and his family own not more than 51%.

⁶⁰ Young-Gu Park, *Heavy Industry and Economic Concentration in the 1970s*, 21 *ECON. RESEARCH* 207, 221 (2003).

⁶¹ *Id.*

⁶² *Id.* at 222.

not allowed because of the one share-one vote principle in the *Sangbeob* [Commercial Code] (“Commercial Code”).⁶³ In addition, cross-ownership in the enterprise group, which is subject to KFTC surveillance, is strictly prohibited by the MRFTA. Most *chaebols* are included in the enterprise group. The MRFTA provides that any company belonging to an enterprise group cannot, in principle, acquire affiliated companies’ stock if the affiliated companies already own this company’s stock.⁶⁴ For example, in Figure 1, because Company A owns 10% of Company B’s stock, Company B is not allowed to acquire even one share of Company A, the company that belongs to the same enterprise group.

In reality, however, the *chaebol* circumvents this restriction through “circular-ownership.” For instance, instead of directly acquiring Company A’s stock, Company B holds 30% of the stock of Company C, which, in turn, owns 5% of Company A’s stock. The bold arrows in Figure 1 represent the circular-ownership relationships. Through such circular-ownership, the *chaebol* achieves the same economic results as it does by means of cross-ownership.

In addition, the holding company, which is commonly found in pyramidal conglomerates across the world, was, prior to the economic crisis, forbidden in order to curb economic concentration of wealth. The MRFTA was amended in 1999 to allow holding companies,⁶⁵ but such companies are still subject to restrictions on their ability to raise debt and hold subsidiaries’ shares.⁶⁶ In fact, the KFTC now encourages the *chaebol* to resolve complex shareholding and then transition to a holding company system.⁶⁷

While the most popular ways of achieving the CM structure were prohibited or limited in Korea, the founders and their heirs developed the *chaebol* into a pyramidal structure, consisting of one or more *de facto* holding companies and numerous subsidiaries connected through an interlocking web of shareholding. The *chaebol’s* CM structure was therefore established through a matrix form of shareholding,⁶⁸ which enables the dominant family to control the entire conglomerate with a fraction of its equity.

⁶³ Bebhuck et. al., *supra* note 38, at 297-301.

⁶⁴ Commercial Code, art. 369 (1).

⁶⁵ MRFTA, art. 9 (1).

⁶⁶ MRFTA, art 8-2 (1).

⁶⁷ MRFTA, art 8-2 (2).

⁶⁸ THE FAIR TRADE COMMISSION OF KOREA, *supra* note 13, at 11-14.

II. AGENCY COSTS IN THE *CHAEBOL* SYSTEM

Numerous *chaebol* subsidiaries are involved in various industries. Accordingly, individual companies are often run by professional managers⁶⁹ as well as by family-managers. At the same time, an entire *chaebol* is under the strong influence of a dominant family. In this setting, the professional managers might exercise discretionary power in their own best interest at the expense of shareholders. Likewise, the dominant family might act in its own best interest to the detriment of non-controlling shareholders. Therefore, the *chaebol* system generates two forms of the principal-agent problem: (1) the agency problem that arises between professional managers (agent) and all stockholders (principal) and (2) the agency problem that arises between controlling stockholders (agent) and non-controlling outside stockholders (principal). Expressed differently, the controller of the *chaebol* is a principal with respect to the professional managers, but an agent with respect to the outside stockholders.

In terms of *chaebols'* corporate governance, protecting the outside shareholders is important. Unlike the dominant shareholder of the *chaebol* who is usually able to handle the professional managers on his own through leveraged voting power, the outside shareholders are usually unable to do so on their own because their voting rights are, in most cases, ineffectual. In this sense, the public shareholders of *chaebol* firms are most vulnerable to principal-agent problems.

Because of this vulnerability, public investors might be reluctant to participate in the Korean stock market, of which *chaebol* firms⁷⁰ account for a significant proportion. Even when they decide to invest, the investors would request more discounts.⁷¹ As a result, the corporate cost of capital would end up rising. In this sense, the protection of the outsider stockholders would contribute to lowering the cost of financing through the stock market. The cheaper external equity financing, in turn, affects profitability, economic growth, and international competitiveness.⁷²

⁶⁹ Song, *supra* note 3, at 200.

⁷⁰ "Professional managers" is used to differentiate non-family member managers from family member managers.

⁷¹ Firms belonging to the 10 largest *chaebols* account for 9.9% of listed companies but 52.1% of capitalization in the Korean stock market. See *infra* Table 6 in Part III.

⁷² In a public corporation with a controlling shareholder, the trading price of shares reflects the value of a non-controlling share, which will have been discounted by the capi-

A. *The Dynamics among Constituencies within the Chaebol*

Three major participants in the *chaebol's* agency cost game are managers, *controlling* stockholders and non-controlling stockholders. Obviously, all three parties attempt to maximize their benefits. Accordingly, their interests sometimes agree, but also sometimes conflict. For *instance*, if a manager is a family member he would rarely engage in any activities harmful to the dominant family. However, the family-manager and controlling family, as a group, are more likely to waste or divert corporate assets for their own interests.

The following example illustrates this point. Suppose that there are two companies (A and B), both of which are run by a family-manager. It is assumed that Company A's total shares are owned by a dominant family, whereas 50% of Company B's shares are owned by the dominant family, and the rest are owned by outside shareholders. In this case, the family-manager of Company A has little incentive to transfer wealth from Company A into the family's pockets because all corporate assets of Company A already belong to the family. Meanwhile, the family-manager of Company B is more likely to transfer wealth from Company B into the family's pockets because 50% of the transferred wealth comes out of the outside shareholders' pockets.

On the other hand, if a manager has no special relationship with the controlling family, shareholders' identities would rarely affect its act of extracting private benefits. Therefore, the family and outsiders share a common interest in curbing agency costs arising from the professional manager. In this case, both controlling and non-controlling shareholders will pay attention to preventing a professional manager from securing his private benefit. Indeed, controlling shareholders—including *chaebol* families—are likely to devote themselves to minimizing agency costs arising from professional managers. Accordingly, the outside shareholders could “free-ride” the dominant shareholders in overseeing the professional managers.⁷³

However, when the dominant shareholder's interests conflict with those of the outside shareholders, the outsiders experience

talized value of the controlling shareholder's private benefits. See Ronald Gilson & Jeffrey Gordon, *Controlling Controlling Shareholder*, 152 U. PA. L. REV. 785, 787 (2003).

⁷³ Kenneth Scott, *The Role of Corporate Governance in South Korean Economic Reform*, 10 J. APPL. CORP. GOVERNANCE 8, 10 (1998).

difficulties in protecting themselves. Even worse, in such a conflict of interest situation, the professional managers often side with the controller because their position is dependent on the dominant shareholder more than on the outside shareholders. As a result, an agency cost problem between controlling shareholders and non-controlling shareholders tends to loom large in the *chaebol*. In this sense, the outside shareholders of *chaebol* firms confront a trade-off between the agency problems of professional managers and those of a controlling shareholder.⁷⁴

B. *Reduction in Managerial Agency Costs in the Chaebol*

Although it is still observed that many family members undertake the management of affiliate companies, professional managers have recently become more important in the *chaebol*. One of the main reasons for increasing dependency on professional managers is the fact that many *chaebols* have become so extensive that family members cannot afford to run all the member companies. For instance, as of 2003, each *chaebol* held an average of 17.2 subsidiaries.⁷⁵ The trend of reliance on skillful and knowledgeable managers has recently intensified as the pool of managers expands, and product market competition is becoming fierce. Inheritance is an additional factor for reliance on professional managers because some heirs lack the motivation or talent to run the conglomerate.

Besides conventional mechanisms found in the law, such as independent directors or derivative suits, many *chaebols* have implemented their own monitoring systems to avoid or limit the extent of professional executives' theft or incompetence. Sophisticated selection through inside competition among employees, strict supervision, and appropriate compensation by the *chaebol's* headquarters could contribute to reducing the agency problems resulting from the employment of professional managers.

Indeed, many successful *chaebol* families often respond to managerial agency cost problems with the help of specialized staff. As a matter of fact, most *chaebols* have personnel to support and assist the chairman of the conglomerate. To illustrate, the Samsung *chaebol* first invented a group-level staff organization by introduc-

⁷⁴ In a Coasean world, the outside shareholders and the controlling shareholder could negotiate *ex ante* the amount of the private benefit of control. In this case, the outside shareholders will allow the controlling shareholder to extract his control rents to the extent that the reduction in managerial agency costs exceeds the private benefit of control.

⁷⁵ Gilson & Gordon, *supra* note 72, at 785-6.

ing the “Office of Secretaries” in 1959. The LG *chaebol* also created the “Office of Chairman” in 1966. The SK, Daewoo and Hyundai *chaebols* made similar moves in 1974, 1976, and 1979, respectively.⁷⁶

The chairman’s chamber undertakes various group-level tasks. The evaluation of subsidiaries’ management is an important component of this office.⁷⁷ For example, Samsung’s office⁷⁸ consists of a planning team (new investment and management planning), a human resource team, the financial control team (managing group-wide funds), a financial team (external financing), a research team (new business opportunity and market information), an audit team (management evaluation and financial auditing of each affiliate), and a government policy team (information collection related to government policy and lobbying).⁷⁹ This organization is often staffed with the most competent employees in the *chaebol* and serves as the right arm to the chairman.

The professional executives are restrained in the *chaebol* by being given concrete goals to accomplish during their terms. This goal is usually established *ex ante* by the chairman’s office. The chairman’s office also evaluates the corporate performance *ex post* and determines compensation accordingly. Since the chairman’s office retains extensive knowledge about the state of affiliate companies and their executives, including inside information unknown to the market, this evaluation process is usually efficient.

More importantly, only successful managers are promoted to more significant, yet limited, posts in the *chaebol*. Since the manager market remains incipient in Korea, the failure to rise in the *chaebols*’ promotion ladder can be critical to the manager’s career.⁸⁰ Therefore, managers work diligently for the chairman. This loyalty may sometimes cause harm to the non-controlling shareholders, particularly when a conflict of interest between inside con-

⁷⁶ THE FAIR TRADE COMMISSION OF KOREA, 2004 ANNUAL REPORT ON FAIR TRADE 220-21, (2004).

⁷⁷ Chang, *supra* note 12, at 99.

⁷⁸ For the efficiency-enhancing function of the chairman’s office, *see, e.g.*, CHAE-YOON LEE, RUN BUSINESS LIKE SAMSUNG 131-8 (2004). However, this office is also alleged to have been deeply involved in wealth diversion for the *chaebol* family. *See also* KANG, *supra* note 56, at 292 (arguing that, for *chaebol* reform, the chairman’s office should be abolished).

⁷⁹ This office turned into the “Restructuring Headquarters” along with the government-pushing *chaebol* reform program after the economic crisis.

⁸⁰ Chang, *supra* note 12, at 100.

trollers and outside shareholders is involved. In general, however, the existence of the industrious managers in many cases makes the investors—i.e., both the controlling and the non-controlling shareholders—better off.

The collapse of Kia Motors—the eighth largest conglomerate in 1997—is an introductory case regarding opportunism in the form of high managerial agency costs. Prior to the economic crisis, Kia Motors was regarded as an ideal model of Korean firms. Absent controlling shareholders, it was run by professional managers and, unlike *chaebols*, specialized primarily in car manufacturing, instead of resorting to excessive diversification. However, it went bankrupt during the economic crisis, and ironically, one of the leading Korean *chaebols*—Hyundai—eventually took over this conglomerate. Indeed, Lee identifies the reason for this failure as arising from managerial agency costs:

In the case of Kia Motors, which represented widely-held ownership structures, its management and labor union ruined the company by extracting their private benefit. Kia Motors did not have a corporate governance structure to protect shareholders' interests. The company lacked internal monitoring mechanisms by independent directors. Furthermore, hostile takeovers were prohibited by the Security Exchange Act at that time. The General Shareholders Assembly was not able to check the management's mistakes. . . . The labor union requested unreasonable benefits, but the management, who did not have any incentive to protect shareholders' interests, accepted even inappropriate demands. Shareholders and creditors could not control the management, but the labor union could handle it. The outcome was a catastrophe, which is now well known to us.⁸¹

It is important to mention, however, that the dominant shareholders are not always vigilant regarding the managerial agency problems. In other words, the reduction in managerial agency costs may differ from firm to firm. For example, some *chaebols* develop efficient mechanisms for compensating and monitoring the professional managers. These *chaebols* are more likely to succeed because they benefit from competent executives, while curbing potential managerial agency costs. On the other hand, some *chaebols* that do not have such sophisticated mechanisms are more likely to fail. In this regard, *chaebols'* internal control structure over profes-

⁸¹ *A CEO Market is Waking Up*, JUGAN CHOSUN (Seoul), March 14, 2005, at <http://weekly.chosun.com/wdata/html/news/200503/20050307000004.html>.

sional managers provides a partial explanation for the rise and fall of the various *chaebols*.⁸²

To summarize, dominant shareholders' monitoring activities over managers serve outside shareholders' interests. When one considers collective action problems which deter fragmented stockholders from effectively checking managers through proxy contests or litigation, the existence of controlling shareholders in the *chaebol* might assist in policing renegade managers.

C. Agency Cost Problems of Controlling Shareholders

Like managerial agency costs, the agency costs of a controlling shareholder emerge in two basic categories: wasting corporate wealth (mismanagement or shirking) and diverting corporate wealth into his own pocket (tunneling or stealing). Examples of mismanagement are rife in the business world. In the context of the *chaebol*, the inheritance of corporate control to incompetent heirs is one example. On the other hand, tunneling includes, without limitation, outright theft, embezzlement, and misappropriation to more sophisticated self-dealing transactions and misappropriation of corporate opportunities.

To be sure, mismanagement and tunneling are not particular to the *chaebol*. Over time, these issues have been at the center of agency problems of a firm, whether its ownership is widely-held or concentrated. The traditional wisdom of corporate governance reveals that no perfect solution exists for this problem. Countries with different ownership structures resolve the problem differently. For instance, a controlling stockholder acting in bad faith in a CO structure will bear most of the incurred. In addition, banks play an important role in monitoring management in concentrated ownership countries, such as Japan or Germany.⁸³ In the U.S., a renegade manager in a DO structure will face the threat of removal—in the form of hostile takeovers.

In the CM structures, such as the *chaebol*, the controller internalizes corporate losses less often than in the CO structure and faces the threat of removal⁸⁴ less often than in the DO structure.⁸⁵

⁸² LEE, *supra* note 52, at 77.

⁸³ For the detailed history of individual *chaebols*, see CHANG, *supra* note 12; see also LEE, *supra* note 52.

⁸⁴ Scott, *supra* note 73, at 10-13.

⁸⁵ Note that the chance of removal is different in accordance with the origin of the CM structure. For example, dual class stocks practically ban hostile takeovers. However, a

Therefore, it is important to examine how agency costs of controlling shareholders are aggravated in a *chaebol* system.

1. *Mismanagement*

Although a large proportion of business decisions are made by the professional executives of subsidiaries, a controlling shareholder—a chairman—can still make the most significant decisions. Unfortunately, in many cases, a *chaebol's* trouble begins with a controller's arbitrary decision, which is far from maximizing firm value. This dissipation problem is best explained with a simple economic model. Suppose there are two candidate projects for a *chaebol* company: Project 1 is assumed to generate an expected value of \$100, while Project 2 is assumed to generate an expected value of \$70. If this *chaebol* is controlled by a dominant stockholder, X, with 10% cash-flow rights, his expected return from the projects will be \$10 ($\$100 \times 10\%$) and \$7 ($\$70 \times 10\%$), respectively.

In this case, if X has a strong personal attachment to Project 2, which is worth \$10, he would choose Project 2 rather than Project 1. This decision is made because Project 2, even though less profitable from the standpoint of the company, brings more benefits to the controlling shareholder. Furthermore, X is more likely to choose a suboptimal project as his equity share of the company decreases. Table 3 illustrates the business project, which the company will choose, as X's equity shares increase from 10% to 70% by 20% intervals. In this example, Project 2, although less efficient, will be chosen because of his personal preference when X has 10% or 30% of the equity. Conversely, X will choose the more efficient Project 1 as his equity increases to 50% or 70%.

Indeed, due to such a suboptimal business decision, largely influenced by the owner's personal preference, many *chaebols* ended up going bankrupt or suffering from serious financial problems. For example, the Ssangyong *chaebol*, which had a profitable subsidiary in the cement industry, went bankrupt and was eventually dismantled during the economic crisis. The main reason for this business failure was Ssangyong's entry into car manufacturing, which was embarked upon partly because of its owner's personal interest in cars.⁸⁶ Likewise, the failed automobile manufacturing

chaebol system tends to be more vulnerable to hostile takeovers. For details, see *infra* Part IV.

⁸⁶ Bebchuck, *et al.*, *supra* note 38, at 295.

TABLE 3: THE EFFECT OF PERSONAL PREFERENCE
IN CHOOSING PROJECTS

X's equity share in the company	X's gain from Project 1	X's gain from Project 2	The final result
10%	\$10 (\$100x10%)	\$17 (\$70x10%+\$10)	Project 2
30%	\$30 (\$100x30%)	\$31 (\$70x30%+\$10)	Project 2
50%	\$50 (\$100x50%)	\$31 (\$70x30%+\$10)	Project 1
70%	\$70 (\$100x70%)	\$59 (\$70x70%+\$10)	Project 1

business of the Samsung *chaebol* was also reported to have originated from the controlling owner's personal interest.⁸⁷

Mismanagement is likely to become more serious as control of the *chaebol* is transferred from founders to heirs. Obviously, entrepreneurial talents are not inherited from parents as easily as corporate control. Nonetheless, heir-managers attempt to compensate the illegitimacy of control through new ventures. For instance, once heirs inherit the position of chairman, they often declare the "second founding"⁸⁸ of the *chaebol* and recklessly expand business, relying on heavy debt to gain legitimacy by showing their ability.

However, this type of adventure often ends up being a disaster, particularly in mid-sized *chaebols*, which retain the strong characteristic of a family business and thus rely less on professional executives. For instance, the Jinro *chaebol*, which has a monopolistic position in liquor production, specifically *soju*, the Korean traditional liquor, became insolvent when the heir jumped into a distribution industry.⁸⁹ Likewise, the Haitai *chaebol*, one of leading confectionary manufacturers, also failed after the new leader pursued diversification into unrelated areas, such as electronics and machinery.⁹⁰ As with other conglomerates seen in Table 4, which went bankrupt in 1997 because Jinro and Haitai relied heavily on

⁸⁷ *Ssangyong Motor, is it Going to Meet a Proper Owner this Time?*, JUGAN DONG-A (Seoul), December 25, 2003, at 38-40.

⁸⁸ *Will the Inheritance of Control Disappear?*, HANKYORE 21, January 14, 2005, available at <http://h21.hani.co.kr/section-021003000/2005/01/021003000200501110543046.html>.

⁸⁹ CHANG, *supra* note 12, at 178.

⁹⁰ LEE, *supra* note 18, at 635-8.

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debt to finance their businesses, they could not survive a surging interest rate during the economic crisis.

TABLE 4: THE DEBT RATIOS OF BANKRUPT CONGLOMERATES IN 1997⁹¹

	<i>Hanbo</i>	<i>Sammi</i>	<i>Jinro</i>	<i>Kia</i>	<i>Haitai</i>	<i>New Core</i>
Date of bankruptcy	Jan. 23	Mar. 19	Apr. 21	Jul. 15	Nov. 1	Nov. 4
Ranking by assets	14	25	19	8	24	28
Debt ratio	648%	3,333%	4,836%	522%	669%	1,253%

Such mismanagement problems have often resulted in massive socio-economic crisis in Korea. Due to *chaebols'* excessive dependence on bank loans and debt-guarantees among affiliated companies⁹² combined with banks' lax monitoring of debtors, if one of the *chaebol* member companies becomes insolvent, the entire conglomerate tends to fall into a significant financial distress. Moreover, since the *chaebol* runs its businesses in various fields, the collapse of a *chaebol* causes a severe impact on the country as a whole, which can easily result in social turmoil. When the Daewoo *chaebol*, comprised of forty-one subsidiaries with 150,000 employees and total assets of seventy-eight trillion won (equivalent to \$78 billion), became insolvent in 1999, the entire Korean banking system teetered on the brink of failure and unemployment surged, destabilizing the whole society.⁹³ Accordingly, the Korean government attempted to avoid the bankruptcy of a *chaebol* and thus provided a bailout through banks under its influence. This practice created the widespread notion of the "too big to fail" syndrome, which in turn exacerbated the moral hazard problem of *chaebol* managers.

In sum, mismanagement—in particular, reckless expansion—is one of the main issues for which the *chaebol* has been blamed. Combined with the practice of mutual debt-guarantees among member companies, the failure of one subsidiary often sets off a dramatic bankruptcy domino effect for the entire conglomerate. A controlling shareholder's small equity-share might facilitate inade-

⁹¹ *Id.* at 647-49.

⁹² Myung-Soo Hong, A Study on Addressing Economic Concentration Resulting from the *Chaebol*, 33 (2003) (unpublished Ph.D. dissertation, Seoul National University) (on file with Seoul National University Library).

⁹³ The MRFTA has basically prohibited debt-guarantees among affiliated companies of enterprise groups (Art. 10-2) since 1998.

quate business decisions. However, it is noteworthy that besides the controlling shareholders' lack of care, the malfunctioning capital market—for example, lenient credit checks by lenders and the practice of mutual debt-guarantees—exacerbated the problem.

2. *Tunneling*

Absent appropriate scrutiny, the controlling parties often attempt to transfer corporate wealth into their own pocket. This activity could originate in the form of either sheer thievery or sophisticated self-dealing transactions. Although the extent may vary from country to country, a large proportion of self-dealing transactions are viewed as being legal in many jurisdictions. According to Johnson:

[M]uch of the tunneling is legal . . . Such legal tunneling takes a variety of forms, including expropriation of corporate opportunities from a firm by its controlling shareholder, transfer pricing favoring the controlling shareholder, transfer of assets from a firm to its controlling shareholder at non-market prices, loan guarantees using the firm's assets as collateral, and so on. Tunneling can also take the form of financial . . . dilution of minorities being the leading example.⁹⁴

As is the case in shirking, dominant shareholders might have greater incentive to divert firm assets for private benefit as their equity-holding declines. Suppose that a *chaebol* family is involved in a transaction that causes losses to the firm but benefits the family. As the equity of the controlling family decreases it will bear a smaller proportion of the losses of the firm. On the contrary, the family will derive all the private benefits from the misbehavior. Since the family is assumed to control the *chaebol* firm in this example, the decreasing equity-holding results in increasing disparity between the cash-flow rights and voting rights. Put differently, the separation of ownership and control enables the *chaebol* family to shift the harmful effects of their wrongdoing to outside shareholders.

To offer a numerical example, suppose there are two companies, A and B, both of which are under the control of a dominant shareholder X. It is assumed that X owns 30% of Company A's stock and 50% of Company B's stock, while fragmented outside shareholders own 70% of Company A's stock and 50% of Com-

⁹⁴ LEE, *supra* note 18, at 754-7.

pany B's stock. As the result of an inside-transaction between Company A and Company B, Company A is assumed to lose \$100, whereas Company B is assumed to gain the same amount. Company A's losses will eventually be distributed among X and the rest of the shareholders, based on their equity share. X bears a loss of \$30 (30% x \$100), but the outside shareholders bear a loss of \$70 (70% x \$100). However, because X earns \$50 (50% x \$100) through Company B, his final balance is a gain of \$20.

Moreover, as mentioned above, this type of value-diverting transaction will look more attractive to X as his share in Company A decreases. Table 5 presents the balance of X with his varying equity share in A. X owns 50% of Company B's stock, but his equity share in Company A varies from 10% to 70%. The table suggests that, everything else being equal, X is more likely to conduct an asset-diverting transaction when he holds less of Company A's stock. For instance, in Table 5, when X holds 10% of Company A's stock, he will eventually gain \$40 from an inside-transaction between Company A and Company B. Conversely, when X holds 70% of Company A's stock, he will finally lose \$20 from the same inside-transaction, because X internalizes more of Company A's losses as his equity share in the company increases. Therefore, tunneling in the *chaebol* is likely to occur in the form of wealth transfer from one company with an owner's small equity share to another company with his large equity share.

TABLE 5: A DOMINANT SHAREHOLDER'S BALANCE
FROM AN INSIDE TRANSACTION

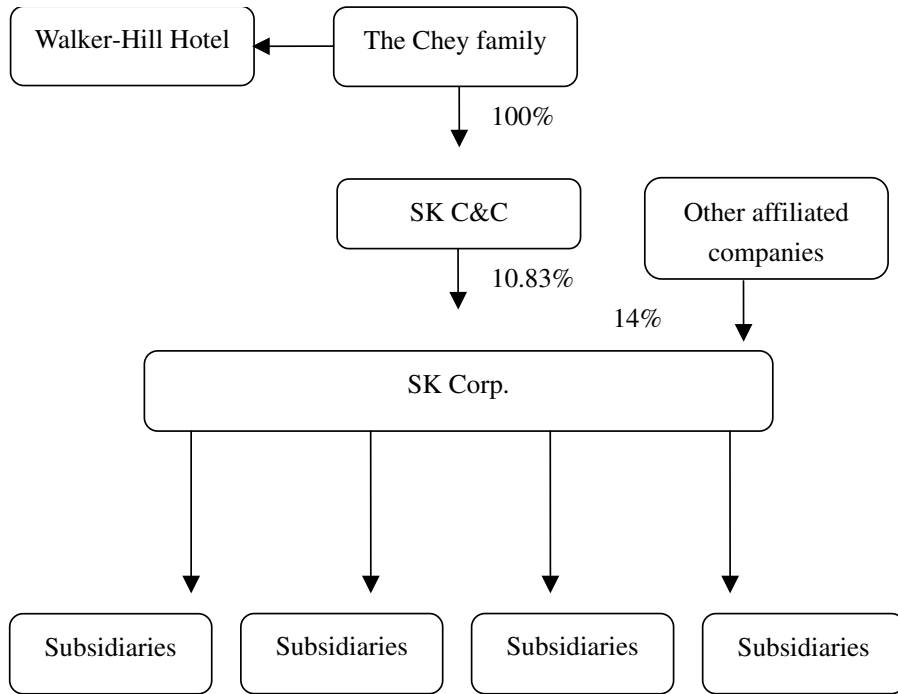
X's equity share in A	X's equity share in B	X's Loss as A's stockholder	X's Gain as B's stockholder	The final balance of X
10%	50%	\$10	\$50	\$40
30%	50%	\$30	\$50	\$20
50%	50%	\$50	\$50	\$0
70%	50%	\$70	\$50	-\$20

Tunneling is a form of sophisticated transactions that is harder to detect than outright theft. For instance, a controlling party often uses preferential treatment toward the dominant family or exaggerated evaluation of corporate assets or securities.

The recent *SK* case exemplifies how tunneling can be used to avoid incremental takeover threats. The *SK chaebol*, a conglomerate of telecommunications, oil refineries, and merchandising, was

controlled by the Chey family. More specifically, many SK *chaebol* firms were controlled by the SK Corp., Korea's biggest oil refiner and a *de facto* holding company of the SK *chaebol*, which, in turn, was controlled by the Chey family through SK C&C and other affiliates. In fact, SK C&C and other affiliated companies held approximately 25% of the SK Corp.'s equity. However, the controlling family controlled the SK Corp. without holding any of its equity.⁹⁵ Figure 3 illustrates the simplified ownership structure of the SK *chaebol*.

FIGURE 3: THE OWNERSHIP STRUCTURE OF THE SK CHAEBOL⁹⁶



With the reinforcement of the ceiling on intra-group shareholding⁹⁷ in 2001, the Chey family became unable to exert leveraged voting power on the SK Corp. through the member companies, such as SK C&C. Of the 10.83% of the SK Corp.'s

⁹⁵ Johnson et al., *supra* note 25, at 26.

⁹⁶ The Seoul District Court 2003, 237 & 311 (June 13, 2003) (unpublished) (on file with the electronic archive of the Supreme Court of Korea).

⁹⁷ Source: Based on the factual finding of the Seoul District Court 2003, 237 & 311, *supra* note 96.

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shares owned by SK C&C, approximately 9.5% were deprived of voting rights. As a result, the family would have lost control over a large part of the conglomerate.

To maintain control by increasing ownership of direct equity shares of the SK Corp., Tae-Won Chey—the controlling shareholder, CEO of the SK Corp. and director of SK C&C—exchanged 40.7 percent of his stock of the unlisted Walker-Hill Hotel with 5.09 percent of the listed SK Corp.'s stock owned by SK C&C, at a ratio of 1:2. Although it was difficult to accurately evaluate the value of the unlisted stock, circumstantial evidence reveals that the unlisted stock price was inflated in favor of the chairman and that Mr. Chey was aware of this fraudulent evaluation. As a result, he was convicted of misappropriation of other shareholders' funds in a criminal trial.⁹⁸

3. *Limits on a controlling shareholder's agency costs*

Because the dominant family retains control with only a small proportion of stocks, mismanagement and tunneling is more likely to occur in the *chaebol* than in other business structures. However, outside stockholders are rarely able to protect themselves with voting rights. Because the controlling family dominates the board and appoints management that serves the family's interest most, outsider voting rights become ineffectual, except in the most important cases, which require super-majority votes.⁹⁹ Furthermore, collective action problems among outsiders often intensify the difficulties in overseeing the chairman.

However, some factors constrain a controlling shareholder's ability to personally benefit. First, the controlling shareholder has to consider expected sanctions for inappropriate behavior. Obviously, the controller would attempt to shirk or steal only when he can derive private benefit exceeding private cost, which includes expected sanctions either from markets or from law-enforcement. In other words, if appropriate conflict of interest laws and efficient capital markets are in effect, the cost of corporate misbehavior (in the form of criminal charges, plummeting stock prices, and hostile takeover threats) will increase.

⁹⁸ I will thoroughly discuss in Part III a restriction on intra-group shareholding.

⁹⁹ Tae-Won Chey was sentenced to three years of imprisonment by the district court. Seoul District Court 2003, 237 & 311, see *supra* note 96. He appealed, and this case is still pending in the Seoul High Court as of March 21, 2005.

Second, reputation limits the extent of extracting the private benefit of control. Many controlling shareholders of the *chaebol* possess more than enough money to spend in their lifetime. Although the small amount of money acquired through tunneling does not dramatically increase their utility, the action of tunneling can damage reputation in Korean society. For example, the founder of the Hyundai *chaebol* and one of his sons were able to run for the presidency in 1992 and 2002 respectively, primarily based on the significant social influence of their lending companies in various industries. Therefore, instead of behaving in a reprehensible manner, the controller of the *chaebol* often preserves his reputation as a national figure.

Third, due to the strong legacy of Confucian culture, a *chaebol* is still regarded as a proxy of a family. Therefore, controlling shareholders would like to transfer control to their heirs. To the extent they believe *chaebols* belong to their family, the controlling shareholders are likely to hesitate extracting excessive private benefits.

The remainder of this article is primarily devoted to addressing the issue of sanctions against controlling shareholders imposed by regulators (Part III) and the market (Part IV).

III. THE GOVERNMENT'S MONITORING ACTIVITIES

Curbing a controlling shareholder's agency costs is closely related to the efficiency of the *chaebol* system. Critics describe the *chaebol* system as "imperial" or "dictatorial." Such characterizations stem from the fact that its ownership structure has often been used to exclude outside shareholders. Non-controlling shareholders lack any effective means of deterring insiders from extracting private benefit. Because an internal governance system proved to be ineffective, an external governance system has become important.

Until recently, external devices used to discipline managers in advanced economies, such as markets for corporate control or main banks,¹⁰⁰ were virtually lacking or inactive in Korea. Instead, it was the government—more specifically, the KFTC—that performed most monitoring activities over the *chaebol*-controllers,

¹⁰⁰ For example, amending articles of incorporation requires the affirmative votes of no less than two-thirds of the shareholders present at the general meeting and of no less than one-third of the total outstanding shares (Commercial Code, art. 433 (1) and 434).

largely based on the authority guaranteed in the MRFTA. Unfortunately, government regulations have been ineffective in aligning the interests of dominant shareholders with those of outside shareholders.

A. *Background*

Regulators and a substantial body of literature have approached the *chaebol* problem, focusing more on economic concentration, market dominance and excessive diversification than on controller's misappropriation. In addition, a substantial body of literature has approached the *chaebol* problem.¹⁰¹ During the pre-crisis period, protection of the outside shareholders was rarely prioritized in the regulation of the *chaebol*.

Pro-bono activities of domestic organizations and increased foreign investment have contributed to changes in the situation. For instance, the People's Solidarity for Participatory Democracy (PSPD), a domestic civic watchdog group, started the minority shareholders' campaign¹⁰² in 1997. It primarily targets *chaebol*-affiliated companies, such as Samsung Electronics, SK Telecom and Hyundai Heavy Industry. The PSPD successfully brought preferential treatment of a dominant family or a subsidiary into the public sphere. For instance, it brought derivative lawsuits against the dominant family and its so-called "servant employees," accusing them of stealing corporate assets.¹⁰³

Foreign investors also began asking the *chaebol* for a higher standard of corporate governance. Table 6 illustrates that foreign investors currently hold a significant block of *chaebol* stock.¹⁰⁴ Therefore, dominant families cannot entirely ignore their demands.

¹⁰¹ A poor banking system is often cited as a cause of the economic disaster in the late 1990s. See, e.g., Yoo, *supra* note 8.

¹⁰² See, e.g., Hong, *supra* note 92.

¹⁰³ The minority shareholders here should be differentiated from the controlling minority shareholders of the *chaebol*. This campaign is primarily for the protection of the 'non-controlling' minority shareholders.

¹⁰⁴ The *SK* and *Samsung Electronics* cases, which we will analyze below, were originally initiated by the PSPD. A more detailed explanation of the PSPD's activities is available at http://eng.peoplepower21.org/contents/actionbody_economy.html (last visited April 1, 2005).

TABLE 6: THE FOREIGN OWNERSHIP OF THE *CHAEBOL*¹⁰⁵

<i>Chaebols</i>	Number of Public Companies	Amount of Market Capitalization*	Proportion of Foreign Investor Ownership
Samsung	14	964,180	54.10%
LG	12	212,372	27.60%
SK	11	264,601	34.70%
Hyundai Motor	6	230,260	44.00%
Hanjin	7	36,017	27.10%
Lotte	5	39,571	35.10%
Hanhwa	4	17,451	17.40%
Hyundai Heavy Industry	2	30,096	20.80%
Hyundai	4	24,256	12.20%
Geumho	3	3,184	1.20%
Subtotal of 10 <i>Chaebols</i>	68	1,821,988	44.4%
Total Public Companies	683	3,492,997	N/A

* 100 million won (equivalent to \$100 thousand)

Foreign investors are often experienced in monitoring managers or controlling families and evaluating their performance because of their expertise in international capital markets. More importantly, foreign investors, unlike domestic institutional investors, are relatively free from the influence of the Korean government. Shareholder activism, initiated by domestic organizations and foreign investors, brought greater attention to the state of corporate governance in *chaebol* firms.¹⁰⁶

B. *Legal Rules: A Restriction on Intra-Group Shareholding*

In terms of corporate governance, one of the most important and controversial legal rules is the ceiling on the total amount of intra-group shareholding. The MRFTA limits individual affiliated companies from holding other affiliated companies' equity when the companies belong to an enterprise group with more than 6 trillion won (equivalent to \$6 billion) in assets. Such an enterprise

¹⁰⁵ The Asian financial crisis in the late 1990s had little effect on the proportion of equity shares between insiders and outsiders of the *chaebol*. However, there have been significant changes in the composition of outside shareholders; foreign investors' equity-holding has increased dramatically. The fraction of foreign investment in the Korean stock market has expanded from 13.7% in 1997 to 36.6% in 2001. Furthermore, this ratio is higher in major *chaebol* member firms. See Kim, *supra* note 29.

¹⁰⁶ The Korea Stock Exchange as of December 12, 2003.

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group is defined as a shareholding-capped enterprise group.¹⁰⁷ More specifically, a member company of the shareholding-capped enterprise group cannot acquire other affiliated companies' shares surpassing 25% of its net assets. The net assets of a company refer to the amount obtained by subtracting the amount of equity investment made by the company's other affiliates in the company from the larger amount between the company's capital sum and equity capital.¹⁰⁸ For example, if a company's capital sum¹⁰⁹ is \$5 billion and other affiliated companies hold its stock with a total par value of \$1 billion, the company's net assets are \$4 billion (\$5 billion - \$1 billion). Therefore, the company could own the stock of the affiliated companies which do not hold its stock up to \$1 billion (\$4 billion x 25%).

This rule was first promulgated in 1986 and aimed to prevent the *chaebol* from excessive expansion.¹¹⁰ However, in 1998, the rule was repealed in a new post-crisis environment in which "concerns about reckless diversification of firms decline because combined financial statements are introduced, corporate governance is improved, and hostile takeovers by foreign investors are allowed."¹¹¹ After its abolition, however, the intra-group shareholding among *chaebol* affiliates surged in 1998 and 1999.¹¹²

As a result, in 1999, the legislature reinstated the equity-holding constraint, which has been enforced since 2001. This time, the rule was intended to reduce the disparity between the cash-flow rights and voting rights, rather than to restrict reckless expansion.¹¹³ Essentially, lawmakers recycled a provision once used to

¹⁰⁷ The economic crisis in the late 1990s began with the shortage of foreign currency. Therefore, the Korean government adopted a positive attitude to attract foreign investors. The Korean government regards improving corporate governance as one good way to facilitate their investment.

¹⁰⁸ MRFTA Art. 10 (1); *Dokjeom Gyuje Mit Gongjeong Georae Gwanhan Be-obryulSihaengryung* [Enforcement Decree for the MRFTA] art. 17 (2).

¹⁰⁹ MRFTA art. 10 (2) (i) (the amount of equity investment is calculated by multiplying the number of stocks in possession as of the closing date of the immediately preceding business year with its face value; the capital sum and equity capital are those entered on the balance sheet of immediately preceding business year).

¹¹⁰ For simplicity, Company A's capital sum is assumed to be the same as or more than its equity capital.

¹¹¹ The official reason for the revision of the MRFTA of December 31, 1986 is available at <http://www.moleg.go.kr>.

¹¹² The official reason for the revision of the MRFTA of February 24, 1998 is available at <http://www.moleg.go.kr>.

¹¹³ See *infra* Figure 4 in Part III.

prohibit *chaebols* from over-expansion to protect *chaebols'* outside shareholders.

At present, the KFTC plans to set a graduated standard for a ceiling on intra-group shareholding. Regulators plan to link improvement in corporate governance to an exemption from equity-holding constraints. Companies falling under one of the following categories will be exempted from the regulation: (1) those with good corporate governance, armed with effective internal monitoring systems, such as cumulative votes, written votes and an inter-affiliate transaction committee¹¹⁴ consisting of outside directors; (2) those that transition to a holding company structure; (3) those which have cross-shareholdings with fewer than five affiliates; and (4) those with a small disparity between cash-flow rights and voting rights—more specifically, with a DR that is no more than 25%, and a VRM that is no more than three.¹¹⁵ With regard to the fourth exemption requirement, the KFTC appears to adhere to the idea that “the more disparity, the less efficiency.” Regulators¹¹⁶ may have thought that if the legal rules prevented the gap between cash-flow rights and voting rights from enlarging through the ceiling on intra-group shareholding, the wealth-diversion in the *chaebol* would be limited. Surely, optimistic views regarding the efficacy of this rule exist. For example, according to the Korea Fair Trade Commission, “Its [KFTC] regulation of cross-shareholding has also barred *chaebols* from controlling affiliates without real infusion of capital. Continued enforcement of such regulations will help reduce explicit expropriation of minority shareholders and subsidies to poorly performing affiliates.”¹¹⁷

Conversely, the efficacy of this type of direct regulation is skeptical. The remainder of this section explores the limits of regulators' intervention in ownership structures.

¹¹⁴ So-Mi Seong, *IMPROVING REGULATION OF ENTERPRISE GROUPS* 11 (2001).

¹¹⁵ This requirement is consistent with what I suggest in Part IV as a way of reducing tunneling among *chaebol* firms.

¹¹⁶ THE FAIR TRADE COMMISSION OF KOREA, A Report to the National Assembly of October 18, 2004. With respect to the DR and VRM, *see supra* Part I.A.2.

¹¹⁷ In Korea, most bills are proposed by the administrative branch instead of congressmen. Therefore, government agencies play a key role not only in enforcement but also in establishing a *chaebol* policy.

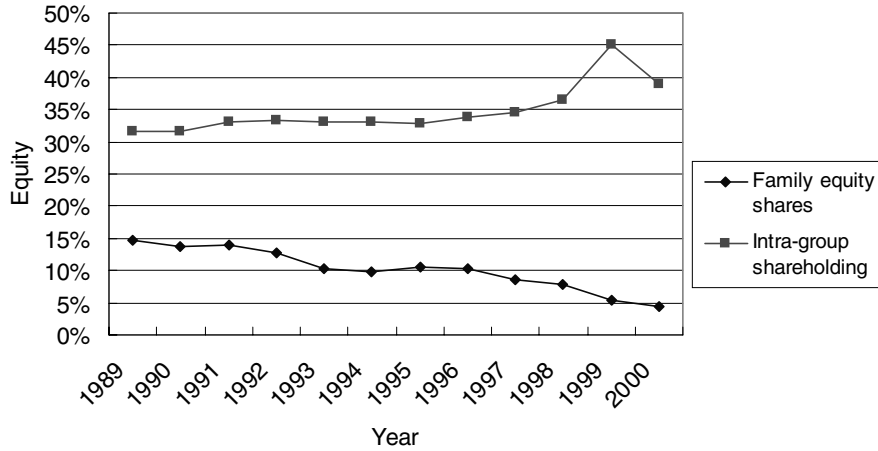
C. *The Outcome of Regulation*

Unfortunately, government regulation, such as the restriction on intra-group shareholding, has not been as effective as the regulators had hoped. Despite regulation, the disparity has increased over the last twenty years. Because of varying concerns, the regulators failed to enforce the rule consistently. In addition, as a matter of theory, the ceiling on equity ownership constrains *chaebol* firms' investment decisions and thus results in unnecessary inefficiency. To reduce this problem, the MRFTA allows lenient exceptions to this regulation which, in turn, make it more difficult to accomplish the original policy goal. Consequently, the limit on *chaebols'* equity shareholding offers an example where the motive for regulation is sound, but the results are nevertheless disappointing.

1. *The Increasing Gap between Ownership and Control*

Figure 4 illustrates that the dominant families' equity has declined since 1989.¹¹⁸ The restriction on intra-group shareholding was repealed between 1998 and 2000. However, even without taking this period into consideration, the trend of families' declining equity share and rising intra-group shareholding was obvious. Expressed differently, the dominant families have consistently relied on intra-group shareholding to maintain control, regardless of government efforts in reducing the disparity. As a result, the gap between cash-flow rights and voting rights has increased.

¹¹⁸ CHANG, *supra* note 12, at 238.

FIGURE 4: CHANGES IN *CHAEBOLS'* INSIDE OWNERSHIP¹¹⁹

2. *Unnecessary Inefficiency*

More importantly, by restricting the range of available organizational options, this regulation creates inefficiency. For instance, suppose that a *chaebol* would like to start a new business. It can add a division to an existing firm or establish a new company to conduct the business. Entrepreneurs will consider many factors when deciding between the two available options. For example, if a business confronts high risks but yields high profits, the *chaebol* would prefer to establish an independent corporation that enjoys limited liability and thus has a smaller impact on other on-going businesses.

Under the current restriction on shareholding, *chaebol* firms are severely restricted from establishing subsidiaries on their own. Therefore, a firm may abandon a risky yet profitable project because of limitations on equity-holding. This means that the *chaebols* face serious obstacles in using limited liability institutions for reasonable purposes. Therefore, the result is socially undesirable.

3. *Lenient Exceptions*

Faced with dilemmas, regulators provided relatively lenient exceptions to the shareholding constraint. To illustrate, *chaebol* companies are allowed to own other companies' shares to the ex-

¹¹⁹ The data regarding *chaebols'* inside ownership first became available in 1989.

tent that such ownership will enhance the international competitiveness of the industry or facilitate corporate restructuring.¹²⁰ Acquiring the stock of foreign companies, of which foreign investors own more than 10%, is also permitted.¹²¹

As seen in Figure 4, *chaebols'* intra-group shareholding has never been below the 25% threshold. This is largely due to lenient "exception" provisions. In fact, these exceptions are also influenced by industrial concerns. The government cannot actively support specific industries as it did in the 1960s and 1970s. Instead, the regulators seem to favor *chaebols* following the government's industrial policies by exempting those *chaebol* firms from the restriction imposed on enterprise groups. But this attitude precludes the regulation from achieving its goals.

In some cases, the *chaebol* might attempt to circumvent the restriction. For example, many *chaebol* affiliates could jointly invest less than their 25% of net assets in a new venture. This joint investment would not violate the rules in the MRFTA, but would further complicate the interlocking web of shareholding among subsidiaries.

4. Summary

Although the limit on stockholding among *chaebol* affiliates is intended to curb mismanagement or tunneling by the dominant shareholder – accomplished by reducing the disparity between cash-flow rights and voting rights – the current regulation has proved to be ineffective in achieving this goal. Even worse, despite the regulation, the gap between ownership and control has widened. This outcome evinces the shortcomings of direct government regulation of *chaebol's* ownership pattern. Therefore, we must consider a new role for the government as a monitor over the controlling shareholders of the *chaebol*.

IV. MARKET INTRUSION AND CONFLICT OF INTEREST LAW

This section explores alternatives to the current ineffective government regulations discussed in Part III. Similar to other business organizations, two forms of agency costs are problematic in the *chaebol*: mismanagement and tunneling. The experiences of

¹²⁰ THE FAIR TRADE COMMISSION OF KOREA, 20 YEARS OF THE FAIR TRADE COMMISSION: A TRACK OF PROMOTING MARKET ECONOMY (2001).

¹²¹ MRFTA, art. 10 (1) iv.

economically developed countries demonstrate that legal rules are ineffective deterrents for mismanagement. However, appropriate regulation of self-dealing can reduce the extent to which the private benefit of control results from tunneling. Incremental market pressure—particularly, the potential market for corporate control—will accelerate a change in the *chaebol's* ownership pattern. Government agencies should show more effort to facilitate capital markets rather than attempting to alter the *chaebol* through direct actions. Self-dealing is the main aspect of *chaebol* problems that remains to be regulated. Consequently, regulators and courts should pay more attention to interested party transactions that transfer corporate assets to those who control a company.

A. *The Need for Market Pressure*

Monitoring controlling shareholders has not been instituted in the *chaebol's* internal corporate governance structure. In fact, the market has played only a small role in disciplining the controllers of the *chaebol*, even when they have been involved in bad-faith behavior that lowers firm value. One of the reasons for such ineffectiveness is the government's excessive involvement in the market. For instance, state intervention in the stock market has prevented stock prices from adequately reflecting corporate performance. Banks, which are under the strong influence of the government, allocate money according to the authority's direction and pay little attention to *chaebols'* managerial ability or profitability in making lending decisions or extending credit.

Another important reason for the market's failure to discipline the controlling shareholders is that the market for corporate control became practically nonexistent as a result of the former Security Exchange Act, repealed in 1994. Specifically, Article 200 of the former Security Exchange Act provided that no one except initial owners could retain more than 10% of a corporation's equity, effectively prohibiting hostile takeovers. As a result, in spite of a small equity share, a dominant *chaebol* family could enjoy virtually complete control without worrying about any sanctions from the market.

Under these circumstances, government agencies have almost exclusively engaged in monitoring the *chaebol* and its controller. Many corporate disasters in Korea have been due to mismanagement—e.g., reckless expansion backed by mutual guarantees among affiliated companies. To address mismanagement, regula-

tors prohibited mutual guarantees among *chaebol* member companies and encouraged the *chaebol* to specialize in few industries.

In addition to entrepreneurs' irrational desires to build corporate empires, the banks' inability to investigate the *chaebols'* financial status, and the stock market's inability to evaluate firm value, exacerbated the problem. Strict credit checks and accurate stock prices might have prevented the *chaebol* from expanding recklessly. Therefore, the *chaebol* problem is not merely a problem of management, it is also related to the institution of monitoring the family.

In this regard, the experience of economically-advanced countries provides a lesson; good corporate law can prevent tunneling, but not mismanagement.¹²² In the U.S., if the controlling shareholder appears to benefit at the expense of the controlled corporation (i.e., when the controller gains disproportionately from the contract terms or the enforcement of those terms when the two parties are on opposite sides), the intrinsic fairness standard applies. In that situation, the controlling shareholder bears the burden of proving that the terms of the transaction were intrinsically fair, with the court making a *de novo* determination.¹²³

Breach of duty of care, however, is held to a dramatically different standard. The courts treat business and strategic decisions that even-handedly affect the controlling and non-controlling shareholders as business judgments.¹²⁴ As Arthur R. Pinto states:

[T]he courts will not review a director's decision even if it is a wrong or poor decision. In Delaware, the business judgment rule provides a presumption that in making a decision directors were informed, acted in good faith and honestly believed that the decision was in the best interests of the corporation. As a result of business judgment rule, the courts will defer to the directors' decision which will not be second guessed by the courts. The courts believe they do not have expertise, and it is not their role to make business decisions.¹²⁵

Even in countries with solid corporate law, what effectively eradicates or reduces mismanagement is not law, but professionalism, social norms and, most importantly, market-oriented devices, such as a market for corporate control or competition in product

¹²² MRFTA, art. 10 (1) iii.

¹²³ Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 234 (2001).

¹²⁴ Gilson & Gordon, *supra* note 72, at 791.

¹²⁵ *Id.* at 790-91.

markets. In other words, without pressures from investors (stock market) or creditors (banks), it is hard to address *chaebol's* mismanagement problems, such as Ssangyong's entry into car manufacturing, as noted in Part II.

B. *The Feasibility of Market Discipline in Korea*

One may argue that current *chaebol* regulation is required because Korean capital markets are still too immature to appropriately police a controlling shareholder.¹²⁶ A rather skeptical view of using the market for corporate control is not rare among Koreans. As Lee and Lim point out:

It is too much to expect that the M&A market will work as efficiently in Korea . . . , not only owing to its underdeveloped capital market but also because it will not be acceptable, socially and politically, if frequent and massive downswings and restructuring of corporations by M&A activities result in a serious unemployment problem. Furthermore, the major concern with the recent M&A moves has been that the *chaebols* will become aggressive in expanding business . . . , aggravating the issue of concentration of economic power.¹²⁷

On the contrary, capital markets—aided by deregulation since the 1990s—have recently begun to play an important role in disciplining *chaebol* owners. Of note, Article 200 of the former Security Exchange Act, which prohibited investors other than initial owners from retaining more than 10% of a firm's equity, was repealed in 1994. The abolishment of this provision facilitated hostile takeovers. For example, in 1997, the Daenong *chaebol*, comprised of twenty subsidiaries, was targeted by a domestic bidder after the stock price of its de facto holding company, the *Midopa* department store, plunged due to management failure.¹²⁸ Likewise, between 2003 and 2004, the KCC *chaebol*, which was originally derived from the old Hyundai *chaebol*, attempted to take over the new Hyundai *chaebol*.¹²⁹ Both attempts ended in failure but clearly indicate that the market for corporate control is working.

¹²⁶ ARTHUR R. PINTO & DOUGLAS M. BRANSON, *UNDERSTANDING CORPORATE LAW* 191 (1999).

¹²⁷ THE FAIR TRADE COMMISSION OF KOREA, *supra* note 13, at 11.

¹²⁸ Lee & Lim, *supra* note 10, at 176.

¹²⁹ *Are hostile takeovers vicious?*, HANKYORE 21 April 16, 2003, available at <http://h21.hani.co.kr/section-021011000/2003/04/021011000200304160455012.html>.

After the economic crisis, many barriers to the corporate control market were eliminated. For example, in 1998, a mandatory bid requirement was abolished and foreign investors could then participate in the Korean stock market virtually without restriction. In 2004, domestic private equity funds were able to be established.

The elimination of barriers to hostile takeovers threatened *chaebol* families' control because they maintain control with a tiny equity share. Moreover, *chaebol* firms are not free to defend themselves against takeover attempts by increasing intra-group shareholding, which is limited under the MRFTA.¹³⁰ For this reason, business circles argue that *chaebols* face inverse discrimination (as opposed to foreign bidders) in the case of takeovers.

The aftermath of the *SK* case demonstrates how Korea's deregulated stock market might discipline *chaebol* families in the future. The controlling shareholder's illegal behavior, combined with other *SK chaebol* firms' accounting fraud and mismanagement, caused the stock price of the *SK Corp.* to plummet. Meanwhile, the Sovereign Fund, based in Dubai, became the largest shareholder with a 14.9 % stake in the *SK Corp.*¹³¹ This fund commenced proxy fights against Mr. Chey, *SK's* leader, to change the management.¹³² Although the effort to remove Mr. Chey failed, the proxy contests brought about a significant improvement in the firm's corporate governance. Because the Chey family needed to win more shareholder support, Mr. Chey promised to enhance corporate governance structures in an effort to undercut the Sovereign Fund's plan to do the same. For example, besides installing seven independent directors out of ten board members,¹³³ Mr. Chey

¹³⁰ Note that after Joo-Young Chung, the founder of the old *Hyundai chaebol*, died in 2001, his heirs divided the conglomerate into three smaller yet still significant *chaebols*; *Hyundai Motor*, *Hyundai Heavy Industry* and new *Hyundai*. The beginning of this hostile takeover bid is as follows: after accounting fraud and illegal political donation scandals were revealed, the leader of the new *Hyundai chaebol*, Mong-Hun Chung, committed a suicide in 2003. As a result, the stock price of *Hyundai Elevator*, a *de facto* holding company of the new *Hyundai chaebol*, plummeted. Under this circumstance, *KCC* gathered the stock of *Hyundai Elevator*. However, the regulator ruled that *KCC* bought the *Hyundai Elevator* stocks without due notification to the regulator. Accordingly, *KCC* was ordered by a government agency to sell a 20.78% stake in *Hyundai Elevator*.

¹³¹ THE SAMSUNG ECONOMIC RESEARCH INSTITUTE, THREATS AND DEFENSES OF HOSTILE TAKEOVERS 24 (2003). With respect to the restriction on the *chaebol's* intra-group shareholding, see *supra* Part III.

¹³² *Id.*, at 1-2.

¹³³ The Sovereign Fund's view on this case is available at <http://www.sov.com/skcorp> (last visited April 7, 2005).

forced all family members except himself to resign from the boards of the SK subsidiaries.

The proxy contest between the Chey family and the foreign investor illustrates the fact that even dominant shareholders of *chaebols* now face sanctions from the market when they mismanage firms or are involved in nefarious activities. In turn, this potential sanction implies that the control of the *chaebol* family is no longer stable. As mentioned, in most *chaebols* the controlling family owns only a small equity in the entire conglomerate. Accordingly, the *chaebol* family's control relies heavily on a web of interlocking shareholding among affiliates. As a result, if one of the affiliated companies is removed from this web, the family's grip on the *chaebol* might be threatened.

This new situation indicates that the market is capable of monitoring the *chaebol's* controller. However, the ultimate outcome of this new environment remains ambiguous. For example, increasingly antagonistic attitudes toward hostile takeovers initiated by the *chaebol* supporters and propelled by nationalism¹³⁴ are one obstacle to market discipline.

C. *The Outcome of Market Intrusion*

The intrusion of the capital markets will increase the cost for *chaebol* families to maintain control. In other words, to avoid threats of hostile takeovers, the controlling shareholders of the *chaebol* will have to either raise their firms' market value or raise their equity in the *chaebol*. It is difficult to know how controlling families will handle this choice. Nevertheless, three scenarios appear possible. Due to shareholders' small fraction of equity in *chaebol* companies, the controlling shareholders may: (1) work more diligently to keep the firms' stock prices high enough to avoid hostile takeovers; (2) increase stockholding enough to retain control (given the limit of a controller's wealth, this would be accomplished primarily by selling some subsidiaries); or (3) abandon control and remain an ordinary holder of cash-flow rights.

An example helps to illustrate these scenarios. Suppose that a *chaebol's* controlling shareholder, X, can retain control with only a

¹³⁴ Meanwhile, the Security Exchange Act requires a majority of and more than three independent directors in a listed large-scale corporation, such as the SK Corp. A detailed explanation about the SK Corp.'s corporate governance is available at http://eng.skcorp.com/invest/ir_gov/ir_gov01.asp (last visited April 7, 2005).

10% equity share¹³⁵ when there are no threats of hostile takeovers; however, when threats of hostile takeovers emerge, X needs to hold at least 50% of the equity or has to work eight hours more to retain control. It is assumed that absent hostile takeover threats, the benefit of control is \$100 and the cost of control is \$0.

We can imagine three different cases in which X's cost for an additional 10% of the equity and hourly rate are (\$30, \$10), (\$20, \$20), and (\$30, \$20). First, if X needs an extra \$30 to add an additional 10% to his equity, and his hourly rate is \$10, it costs X less when he increases his working hours—\$80 (\$10 x 8 hours)—than when he raises the equity share—\$120 (\$30 x 40%). By working harder, X can still enjoy the 'net' private benefit of control equivalent to \$20 (\$100 - \$80). Therefore, he would choose to increase his working hours as in Scenario (1).

If instead X needs an extra \$20 to acquire an additional 10% of the company's equity, and his hourly rate is \$20, X only needs an extra \$80 (\$20 x 40%) to retain his control by purchasing more equity, while he needs an extra \$160 (\$20 x 8 hours) to retain control when he increases his working hours. By raising his equity share, X can still have \$20 (\$100 - \$80) of the 'net' private benefit of control. Therefore, he would choose to raise his equity as in Scenario (2).

If instead X needs an extra \$30 to acquire an additional 10% of the equity, and his hourly rate is \$20, increasing his equity and working the additional hours cost him \$120 (\$30 x 40%) and \$160 (\$20 x 8 hours), respectively. Because these costs exceed \$100, the benefit which X can derive from having control, he would do best to abandon control¹³⁶ and remain an ordinary cash-flow right holder as in Scenario (3). Table 7 summarizes these outcomes below.

¹³⁵ Note that, as seen in the *SK* case, many potential bidders are foreign investors.

¹³⁶ In many cases, because of intra-group shareholding, X can exercise leveraged voting rights, which exceed 10% of the equity. However, for analytic simplicity of analysis, I ignore leveraged voting rights and assume that cash-flow rights and voting rights are the same.

TABLE 7: POTENTIAL HOSTILE TAKEOVERS' EFFECTS

Cost of extra 10% equity	Hourly rate	X's choice	Outcome
\$30	\$10	Increasing working hours	Efficient <i>chaebol</i> (Scenario 1)
\$20	\$20	Raising equity	Shift to CO firm (Scenario 2)
\$30	\$20	Abandoning control	Shift to DO firm (Scenario 3)

Scenario (1) indicates an efficient *chaebol*. In fact, if capital markets work well and legal rules fully protect outside investors, the private benefit of control will be extremely small. Nevertheless, despite the small benefit of control, there may still be some families who want to assume the position of controller because Confucian legacy remains strong in Korea—i.e., a *chaebol* might be a family symbol. Besides the family name, the controlling shareholder would likely enjoy non-pecuniary benefits, such as an enhanced reputation or social influence from being the chairman of a *chaebol*. Such intangible benefits increase the controlling shareholder's utility.¹³⁷ Therefore, in some extraordinary cases, controlling shareholders may want to devote themselves to being monitored by the capital market and, at the same time, monitoring professional managers even without having the extra private benefit that comes from shirking or tunneling.

Under Scenario (2), current *chaebol* firms will be more similar to family-controlled firms, i.e., a firm with a CO structure. The *chaebols'* mammoth size will decrease as it divests itself of some subsidiaries. To be sure, the agency-cost problem between the controlling shareholder and the non-controlling shareholder will remain. Whereas the controlling shareholder will presumably internalize the cost of his conduct more than before because of his increased equity share, the lack of external disciplining may cause another problem—i.e., managerial entrenchment. In other words,

¹³⁷ For simplicity, I do not take into account high managerial agency costs. Indeed, if managerial agency costs are unbearably high, the controlling shareholder would not abandon control despite even a negative private benefit of control. However, note that since renegade managers will face hostile takeover threats as controlling shareholders acting in bad faith do, managerial agency costs tend to decline with well-functioning market pressure.

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under this circumstance, the capital market—specifically, a market for corporate control—would not be of much help.¹³⁸

Under Scenario (3), the *chaebol* system will evolve into a widely-held independent company with management leadership—i.e., a firm with a DO structure. Accordingly, the focus of agency theory will move from agency costs arising between controlling and non-controlling shareholders to agency costs arising between managers and all stockholders. This transition does not always result in a reduction of agency costs. Although agency cost problems resulting from the controlling shareholder disappear, managerial agency costs loom large in this type of company.¹³⁹ Nevertheless, the active capital market plays an important role in curbing managerial agency costs.

It is still difficult to predict what the structure of the *chaebol* will be in the future. It is somewhat clear however that market intrusion will bring about a significant change in the *chaebol* system. The main target of market pressure will be an inefficiently-run *chaebol*.¹⁴⁰

D. *The Role of Good Legal Rules*

The above scenarios demonstrate that market pressure will either decrease the private benefit of control and thus make the current *chaebol* efficient, or bring about a change in the *chaebol's* ownership pattern to either a DO or CO firm. In the interim, it is implicitly assumed that the controller would not steal money from the outside shareholders' pockets. However, as seen in the *SK* scandal, questionable self-dealing transactions might give the controlling shareholder added incentives to retain control and engage in questionable practices. This practice is likely to be perpetuated when appropriate conflict of interest laws do not exist or existing law is rarely enforced. In this case, the *chaebol* system might persist without any efficiency enhancement.

¹³⁸ Note that such private benefit of control does not necessarily incur agency costs to outside shareholders as long as the controlling shareholder does not shirk his duty to maximize firm value. To be sure, maximizing firm value is one of the ways to raise the reputation.

¹³⁹ The managerial entrenchment hypothesis contends that increasing insider ownership insulates owner-managers from external disciplines, such as hostile takeovers and, thus, reduces firm value by perpetuating ineffective management. See *supra* note 22.

¹⁴⁰ With respect to the relationship between managerial agency costs and ownership structures, Roe states that ownership cannot readily be separated from control when managerial agency costs are especially high. See Roe, *supra* note 123.

To illustrate this point, one more assumption is added to the above example. Because of the lack of legal rules protecting outside shareholders, X could retain control via tunneling— i.e., buying newly-issued stocks at an unfairly low price. Then, facing hostile takeover threats, X neither increases his working hours nor raises his share of the equity through a normal market transaction.¹⁴¹ Instead, he issues new stocks to retain control.¹⁴² In this case, the current form of the *chaebol* will persist without any significant change.

1. *Different attitudes toward tunneling*

Tunneling occurs in developed economies. However, the level of tunneling varies substantially in response to different legal rules and court attitudes toward such transactions. In fact, the difference between civil-law courts and common-law courts in analyzing self-dealing transactions is remarkable. In civil-law countries, because of the emphasis on legal certainty, self-dealing transactions are assessed in light of their conformity to statutes.¹⁴³ In contrast, the entire or intrinsic fairness test is central to the analysis of self-dealing transactions by common-law courts and the burden of proof in such cases is favorable to outside shareholders.¹⁴⁴

Courts' different approaches to self-dealing transactions affect the controlling shareholder's control rents. If, because of strict re-

¹⁴¹ This prognosis is indeed supported by Gilson, who has observed the hostile takeover boom in the U.S.:

[H]ostile takeovers may be an effective device at breaking up inefficient conglomerates, which requires little internal information to sell off unrelated businesses, while fixing the problems of a single business may require deep local knowledge of the business that may not be available to outside owner.

Gilson, *supra* note 12, at 11.

¹⁴² Note that in the example under good law, X needs to spend at least \$80, whether he raises his equity or increases working hours, to retain control.

¹⁴³ Of course, in a perfect market, the stock price will reflect this questionable self-dealing and, as a result, a plummeting price may make the controlling shareholder vulnerable to hostile takeovers. However, given information asymmetry and the limit of disclosure, some self-dealing might be undertaken without affecting stock prices.

¹⁴⁴ Johnson et al., *supra* note 25, at 23-4; 26. They state:

[C]ourts in civil law countries may accommodate more tunneling than courts in common-law countries because of: (i) a narrower application of the duty of loyalty . . . , (ii) a higher standard of proof in business purpose, (iii) a greater responsiveness to stakeholder interests, and (iv) a greater reliance on statutes rather than fairness to regulate self-dealing transactions.

In the *Samsung Electronics* case, which we shall see below, the Supreme Court of Korea, indeed, did not diverge from such a civil-law court tradition.

view by a court, tunneling through intra-group trades becomes more difficult, the controlling shareholder might have less incentive for group affiliation. Correspondingly, Johnson et. al. state:

Perhaps the reason that pyramidal group structures are relatively rare in the United States and the United Kingdom is that many transactions inside a group would be challenged on fairness grounds by minority shareholders of subsidiaries, who would get a receptive hearing in court.¹⁴⁵

Johnson et al. indicate that the judicial treatment of tunneling might substantially influence the prevalence of stock pyramids in a jurisdiction.

2. *The Samsung Electronics case*

As a matter of fact, the Korean Supreme Court, a civil-law court, did not deviate from the civil-law/common-law distinction. With respect to Samsung Electronics' issuance of convertible bonds ("CBs"),¹⁴⁶ the Korean Supreme Court recently dismissed the claim that Samsung's Lee family—the controlling shareholder—diluted outside shareholders' stakes through a closed subscription to these bonds.

In March 1997, Samsung Electronics issued the 60-billion-won (equivalent to \$60 million) private CBs to the Samsung Corp, a *de facto* holding company of the Samsung *chaebol*, and Jae-Yong Lee, the only son of Samsung's chairman.¹⁴⁷ The CBs could be converted into shares at a price of 50,000 won (equivalent to \$50) per share. The Samsung Corp. and Jae-Yong Lee, then a twenty-nine year-old student, converted the bonds to shares in September 1997. As a result, Jae-Yong Lee and the Samsung Corp.'s equity share of Samsung Electronics increased to 0.9% and 4.5%, respectively. Furthermore, the Lee family could exercise 24.8% of the voting rights, including affiliated companies' equity-holdings of Samsung Electronics.

When Samsung Electronics issued the CBs, its stock price was 56,700 won (equivalent to \$56.7) per share. In May 1997, Samsung Electronics also issued \$300-million in CBs to overseas capital markets, but their conversion price was 123,635 won (equivalent to

¹⁴⁵ *Id.*, at 26.

¹⁴⁶ *Id.*

¹⁴⁷ The CB refers to a type of bond that can optionally be converted into shares of the issuing company at the pre-fixed ratio, for example, 50,000 won per share in this *Samsung* case.

\$123.6) per share. In addition, Samsung Electronics issued new stocks in July 1997, at a price of 68,500 won (equivalent to \$68.5) per share.¹⁴⁸ A minority shareholder¹⁴⁹ filed a suit to nullify the issuance. The plaintiff claimed that Samsung's CB issuance was geared toward transferring control of the conglomerate¹⁵⁰ to Lee, Jr. from his father, and, therefore, the conversion price of the CBs was unfairly favorable to buyers. However, the Korean Supreme Court dismissed the claim, emphasizing legal certainty. The Court reasoned as follows:

Once convertible bonds were issued, the interests of buyers should be considered. In addition, since convertible bonds or stocks converted from the bonds are negotiable, the reliance of third parties should be protected Therefore, the grounds for voidness will be restricted Only when the issuance substantially violates statutes or a charter or is unbearably unfair to the extent which it contravenes the nature of a corporation or the basic principles of corporation law or substantially affects the interests of existing shareholders or the management or control of the corporation.¹⁵¹

Accordingly, the Korean Supreme Court concluded that although the convertible bonds were issued at a relatively low price, the transaction was not "grossly unfair enough" to be nullified.¹⁵²

3. *The need for sophisticated legal rules regarding self-dealing*

As noted above, the *chaebol's* ownership structure is likely to change in response to incremental market pressure. However, without appropriate conflict of interest law, takeover threats might only facilitate more intricate self-dealing transactions, which enable the controlling shareholder to keep his control at the expense of outside shareholders. For example, the *SK* and *Samsung* cases

¹⁴⁸ In principle, existing shareholders of Samsung Electronics would receive a pro rata share of new stocks or bonds. However, its charter allowed the board of directors to sell the bonds to particular individuals or corporations.

¹⁴⁹ The factual finding of this case is primarily based on a lower court's decision. See The Seoul High Court 98na4608 (June 23, 2000) (unpublished) (on file with the electronic archive of the Supreme Court of Korea).

¹⁵⁰ The plaintiff was professor Ha-Sung Jang, who has led the PSPD's minority shareholder activism.

¹⁵¹ The plaintiff alleged that the defendant company was not in financial trouble at the time and did not need to raise funds through the private CBs. But according to the Court, "it is not certain whether or not the defendant company urgently needed fresh money at that time."

¹⁵² The Supreme Court of Korea, 2000da37326 [2004gong1207] (June 25, 2004).

demonstrate that under rapidly changing post-crisis economic circumstances dominant families with only a small equity share are confronting more difficulty in retaining control over their business empire. Therefore, if corporate law allows room for tunneling, these families might attempt unfair transactions to increase their equity-holding. In this regard, regulators should focus more on interested party transactions.¹⁵³

The MRFTA currently has provisions regulating unfair intra-group trades among *chaebol* firms. These regulations include mandatory voting for inter-affiliate transactions, their disclosure to the public, and an administrative charge of unfair inside trades. For example, in a firm belonging to an enterprise group with assets of more than 2 trillion won (equivalent to \$2 billion), the board of directors should vote on financial or real estate transactions with its dominant family or other affiliated firms and the company should disclose these transactions.¹⁵⁴ Furthermore, the KFTC can stop an unfair intra-group transaction by ordering a corrective measure and impose a surcharge up to 5% of its sale on the company involved.¹⁵⁵

Unfortunately, these regulations are not sufficient to effectively respond to the controlling shareholder's tunneling in the *chaebol*. With regard to the voting requirement, it is noteworthy that directors—including most independent directors—are usually selected by the controlling shareholder. That is, the board of directors, which determines the final terms and conditions of inside transactions, is still far from being independent enough to make an arm's length transaction.

Moreover, the regulation of unfair inside trades is not intended to protect outside shareholders; it is rather intended to protect competitors of a preferentially treated party.¹⁵⁶ Therefore, the supervision is not effective in preventing tunneling by a dominant family.

As seen in the *Samsung* case, Samsung SDS—another affiliated company of the Samsung *chaebol*—issued bonds with war-

¹⁵³ *Id.*

¹⁵⁴ Note that the exercise of voting rights rarely helps outside shareholders confront a controlling block.

¹⁵⁵ MRFTA, art. 11-2 (1). This provision, which was promulgated in 1999, applies when the amount of the transaction exceeds 10% of the firm's capital or 10 billion won (equivalent to \$10 million).

¹⁵⁶ MRFTA, art. 23 (1); 24; 24-2.

rants at a lower price in February 1999 and allocated them to the Lee family and two senior executives of other affiliated companies. The KFTC banned the transaction and imposed a surcharge on Samsung SDS. The company filed a lawsuit against the KFTC and the Korean Supreme Court eventually accepted the plaintiff company's claim.¹⁵⁷ In this case, the Court reasoned that the KFTC failed to provide any evidence showing that this transaction hampered competition in the market. Consequently, because the Court required a charge of "harm to competition," this provision proved to be ineffectual in addressing tunneling through self-dealing transactions between *chaebol* family members and affiliated companies.

Given the limits of current legal rules regarding self-dealing transactions, new measures are required to constrain the extent of control rents, which the dominant family could extract through intricate self-dealing. Roughly speaking, both law and governance structures could provide assistance in improving the protection of outside shareholders. Legislation should make it clear that controlling shareholders owe fiduciary duties to outside shareholders and specify procedural requirements for self-dealing. In addition, governance structures should be amended so that independent directors are actually involved in self-dealing and finally determine the terms of the transactions.

Although suggestions about concrete reforms are beyond the scope of this research, one point is worth emphasizing: in guaranteeing an arm's length transaction between a controlling shareholder and a *chaebol* firm, the firm should have some substantial freedom to say "no" in negotiations.

V. CONCLUSION

The existence of controlling minority shareholders in the *chaebol* is a mixed blessing to its outside shareholders. If the controllers are trustworthy and diligent, they may benefit outside shareholders by reducing managerial agency costs, without additional agency costs of their own. Due to their small equity share, the controlling shareholders do not internalize a substantial part of the harm resulting from their mismanagement or tunneling. Therefore, they are more likely to engage in such misbehavior. In this regard, aligning the interests of the controlling *chaebol* families

¹⁵⁷ OH-SEUNG KWON, *ECONOMIC LAW* 286 (2005).

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with those of the outside shareholders is an important issue in *chaebol* policy.

In this sense, the ownership structure of the *chaebol* is neither intrinsically good nor bad. Expressed differently, non-controlling shareholders will prefer the presence of a *chaebol* family to the extent that the benefits from the reduction in managerial agency costs are greater than the costs of its existence.¹⁵⁸ Although the sharp disparity between cash-flow rights and voting rights exacerbates principal-agent problems in the *chaebol*, the agency costs are not unique to the *chaebol*.

Nonetheless, for a long time the *chaebol* controlling shareholders were shielded from market-oriented disciplinary actions due to legal rules and state intervention that barred a capital market from developing. Regulators have continued their efforts to prevent the disparity from expansion, but such efforts have proved ineffective. This experience indicates that the appropriate role of markets and regulations in resolving the *chaebol* problem needs to be reexamined.

Of the two aspects of agency problems, i.e., mismanagement and tunneling, conventional lessons of corporate governance reveal that legal rules and government regulations are not helpful in addressing mismanagement. This task could be accomplished more effectively by efficient capital markets. Recent events in Korea's corporate sector, such as the *SK* case, imply that the deregulated stock market has already started to police dominant stockholders.

Despite incremental market pressure, the government's role is still important. Without appropriate conflict of interest laws and effective enforcement, the market pressure on the controlling shareholder may still be diluted through tunneling. Therefore, Korea needs to have more specific legal rules regarding interested party transactions among *chaebol* firms or between those firms and *chaebol* families. Increasingly antagonistic attitudes toward hostile takeovers, largely driven by political factors such as nationalism, may deter market-oriented monitoring devices. In this sense, the government's commitment to protecting the market from political interests is required.

¹⁵⁸ The Supreme Court of Korea, 2001*du6364* [2004*gong1744*] (September 24, 2004).

