

U.S. STYLE CORPORATE GOVERNANCE IN KOREA'S LARGEST COMPANIES

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With roots in the early part of the 20th century,¹ corporate governance attracted a fresh look in the U.S. in the late 1980's and early 1990's. Maybe this is because the mid-1960s and early 1970s are perceived as a time of "gross corporate waste and mismanagement,"² and the 1980s a decade of crime and greed, insider trading and takeover battles.³ Many blue chips delivered unsatisfactory returns to their shareholders and seemed unable to compete effectively in the global marketplace, but executives of the blue chips paid themselves richly. People wondered about the boards of directors; whether anyone was monitoring the senior managers of the large publicly owned corporations and whether those managers were accountable to anyone. The corporate governance movement experienced a renaissance that progressed along three parallel tracks. First, lawyers wrote about the proper role of an active, independent board of directors with audit, nominating and compensation committees. Second, hostile takeovers were understood as a way of dislodging or energizing inept or entrenched management and of realizing shareholder value. Particularly in the context of M & A transactions, the courts told boards how they ought to behave if their decisions were to merit judicial deference and this helped to shape the role of the board. Third, instead of automatically availing themselves

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1. Nearly every article cites the seminal discussion by Berle and Means of the divergence of interests of owners and managers. *E.g.*, D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from KMart*, 74 N.C.L.REV. 1037, 1057 (April 1996).

2. Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. Sept.-Oct. 1989, at 61.

3. See William Taylor, *Crime? Greed? Big Ideas? What Were the '80s About?*, HARV. BUS. REV. Jan.-Feb. 1992, at 32.

of the "Wall Street Rule" in case of an underperforming investment, institutional shareholders with large holdings, angered by what they considered to be self-serving actions by some corporate managers, demanded by various techniques that firms deliver shareholder value. One of these paths, the transformation of the board of directors of the large U.S. firm, foreshadows what is now happening in Korea. The late 1997 near collapse of the Korean economy is widely attributed, in part, to mismanagement of the chaebols, Korea's large business groups, and to the unrestrained ambition of the chairmen of the chaebols. Many reforms have been proposed and enacted into law in Korea since then, and several concern the structure and role of the boards of directors of large publicly traded corporations, the constituent firms of the chaebols. The Korean government retained a U.S. law firm and a U.S. law professor to advise it, and the new laws have imported U.S. style governance concepts. The Korean corporate culture is radically different, however, and a serious question is whether U.S. legal mechanisms can be airlifted into a Confucian culture.

We will first review the U.S. view of the role, duties and structure of the board of directors of a publicly traded corporation for a frame of reference with which to view the Korean situation. We will then look at the chaebols and their role in the Korean economy from the early 1960s through the 1997 crisis. We will consider the management style of the chaebol, the role of the group chairman, and his effect on the economic performance of the member firms. We will recount the many corporate governance reforms that have been instituted or recommended in Korea during 1998, 1999 and early 2000. These include statutory revisions and the promulgation of a Code of Best Practices. We will examine in detail the revisions that are intended to transform the Korean boards into active, independent bodies because it seems to us that good governance begins with the board. We will also recount the changes to the legal environment of accountants and auditors, to the rights of minority shareholders, and to the conduct of a takeover, although none of them can be as efficient as getting it right in the first place with an honest and diligent board. Finally, we will ask whether the changes have succeeded in bringing a measure of accountability to the group chairman such that a long-term foreign institutional investor might be attracted to Korea's capital markets. Occasionally, we will look at the role of institutional investors because the Korean reforms are designed to attract foreign equity capital.

The importance of good corporate governance

The usual account is based on the U.S. experience with large publicly traded companies, and we offer it with the obvious caveat that each country has its own laws and patterns of corporate existence; indeed, each company has its own business culture and practices. Corporate governance is the solution to a problem inherent in the structure of the modern publicly traded corporation, in which ownership and management are separate. As corporations became giant national enterprises in the early 20th century, shareholders grew in number but became more widely dispersed. A class of professional managers filled the power vacuum left by the declining percentage ownership of the founder. The classic problem is the widely dispersed ownership of the entity, scattered individual shareholders who, because of their relatively small holdings, are unable to police the managers of the firm. The classic solution to this problem has been the board of directors, under whose direction the corporation is to be managed.⁴ Their mission includes overseeing the affairs of the corpo-

4. *E.g.*, "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . ." 8 Del. Corp. Code §141(a) (1999). See James M. Tobin, *The Squeeze on Directors – Inside Is Out*, 49 BUS. LAW. 1707, 1709-10 (Aug. 1994). The board does not operate the business. That is the province of management. Three decades ago, it was understood that the board is supposed to approve certain significant corporate actions, hire the president and exercise judgment as to major policy decisions, *e.g.*, establishing basic objectives and strategies, though it is not clear that boards actually did much of the latter. *E.g.*, MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 139-41 (Little Brown 1976); Melvin A. Eisenberg, *Corporate Governance: The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237 (Sept.-Nov. 1997)(boards of large publicly held corporations "rarely, if ever, performed the management function"). More recent discussions often break board function into two categories: management and oversight. *E.g.*, Jill E. Fisch, *Corporate Governance: Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (Sept.-Nov. 1997); COMMITTEE ON CORPORATE LAWS, *Changes in the Model Business Corporation Act – Amendments Pertaining to Electronic Filings/Standards of Conduct and Standards of Liability for Directors*, 53 BUS. LAW. 157 (Nov. 1997) [hereinafter *Standards of Conduct*].

The management function is usually described to include:

- confirming basic corporate objectives,
- participating in strategic planning,
- selecting competent senior executives,
- advising the CEO,
- reviewing and approving significant transactions, and
- performing tasks assigned by statute (*e.g.*, approving a merger or declaring a dividend).

The oversight function is described to include:

- reviewing financial statements and receiving briefings from senior executives,
- installing legal compliance systems,
- receiving periodic reports on compliance and material litigation,
- reviewing the performance of senior executives,
- evaluating and where appropriate dismissing the CEO, and

ration so that, among other things, the hired managers will not place their own interests above those of the corporation and its shareholders (e.g., pay themselves richly for mediocre performance). There was little incentive for active oversight, however, other than the fiduciary duty imposed by law. In practice, directors were naturally loyal to the chairman/CEO who appointed them, if not formally elected them to office.⁵ As a result, there are well-known horror stories of inept managers, corporate disasters and passive boards.⁶

A corporate governance structure establishes the distribution of rights, powers and duties among the shareholders, directors and managers of a corporation. The goal is to provide an oversight mechanism to select and monitor the managers, to replace poorly performing managers in timely fashion and to provide accountability to shareholders without intruding upon the authority of the managers to conduct the day to day affairs of the business.⁷ The *OECD Principles of Corporate Governance* define corporate governance as:

the structure through which the objectives of the company are set, and the means of obtaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the best interests of the company and shareholders and should facilitate effective monitoring . . .⁸

Particularly in a developing nation such as Korea, corporate governance plays a "central role for bringing about investment and for using investment capital wisely and efficiently."⁹ Good corporate governance helps to build market confidence and to encourage more stable, long-term international investment flows.¹⁰ Institutional investors partly base investment decisions on the

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- seeing that the business is being managed consistently with basic corporate objectives.

Fisch, *supra*; *Standards of Conduct*, *supra*; Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427 (Aug. 1995); Tobin, *supra*; Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25 (Fall 1987).

5. See Sanjai Baghat, et al., *Director Ownership, Corporate Performance and Management Turnover*, 54 BUS. LAW. 885 (May 1999).

6. See *id.*, (recounting events at General Motors, IBM, AT&T, Archer-Daniels-Midland, W.R. Grace and Morrison Knudsen).

7. See generally, Millstein, *supra* note 4.

8. *OECD Principles of Corporate Governance*, <http://www.oecd.org/daf/governance/principles.htm> (May 1999).

9. Joanna R. Shelton, Deputy Secretary-General, OECD, Remarks at the World Bank/OECD Global Corporate Governance Forum, Washington D.C. (Sept. 27, 1999).

10. See *OECD Principles of Corporate Governance, Questions and Answers*, <http://www.oecd.org/daf/governance/Q&As.htm> (last modified Aug. 2, 2000).

likelihood of independent boards, yet an early 1999 survey by a Yonsei University finance professor found that foreign investors rated the governance practices of Korean companies to be "fairly poor."¹¹ Korea has clearly articulated its desire to attract foreign capital and strengthen its institutional investor base. There is a dual purpose to be served. Fresh equity capital will relieve the debt burden of the chaebols, and institutional shareholders can perhaps act as a counterbalance to the power of the chaebol chairman. To this end, Korea opened its stock markets to unlimited foreign investment in May 1998, allowed foreigners to mount hostile takeovers in the same month, and abolished nearly all of its foreign exchange controls in April 1999. Korean policy makers continue to emphasize the need to attract foreign capital.

Our focus is on two of the prescribed solutions to the governance problem. One is to energize the board of directors into assuming a more active monitoring role. The other is to recognize the increasing shareholdings of long term institutional investors, holding 50% - 60% of traded U.S. equities, whose concentration allowed them in recent decades to play corporate cop and who in the mid-1980s began to seek ways to exert themselves as responsible owners in the U.S.¹² A third solution, an open market for corporate control, is less widely embraced as an effective means of overseeing corporate managers.¹³ This is certainly

11. Joon Gi Kim, *Corporate Governance in Korea: Where Do We Go from Here?*, KOREA HERALD, July 21, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. Mr. Kim is a professor at the Graduate School of International Studies at Yonsei University; Park, Sang-Yong, *Enhanced Corporate Governance Will Increase Foreign Investment Sharply*, KOREA HERALD, June 9, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. Mr. Park is a finance professor at Yonsei.

12. See *A Move to Make Institutional Investors Start Using Their Stockholder Clout*, BUS. WK., Aug. 6, 1984, at 70; *Protection Money: Some Shareholders Are More Important than Others. How Can They Be Prevented from Abusing Their Power?*, ECONOMIST, Dec. 11, 1999, available in WESTLAW at 1999 WL 29811965; Richard H. Koppes, et al., *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023 (May 1999) [hereinafter *The Debate*]; Richard H. Koppes, *Corporate Governance*, NAT. L. J., Apr. 14, 1997; Dennis J. Block & Jonathan M. Hoff, *Corporate Governance and Institutional Activism*, N.Y.L.J., Jan. 18, 1996, at 5; See generally MICHAEL USEEM, *INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA* (1996).

13. See Smith, *supra* note 1, at n.189; Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59, 59 & nn.2 & 3 (Nov. 1992); Barry E. Adler & Larry E. Ribstein, *Debt, Leveraged Buyouts and Corporate Governance*, *Cato Institute Policy Analysis No. 120*, <http://www.cato.org/pubs/pas/PA120.HTM> (May 2, 1989). "If management either has acted selfishly or has simply failed to make a change in operations or to seize a business opportunity, an outsider can profit by obtaining control, making the appropriate changes, and reaping the benefits when the stock price rises to reflect the change. But the market for control and other incentives and monitoring devices do not perfectly align management and shareholder interests. Any potential improvement in the corporation

the case in Korea, where only a handful of takeovers have happened. Notably, Samsung attempted a hostile purchase of Kia shares in October 1993 and the effort was condemned as clashing with Korean values. A fourth solution, litigation against malfeasant or dishonest officers to enforce duties of care and loyalty, suffers from the problems of all litigation remedies: expense, inefficiency, uncertainty and after the fact. The duty of care is not difficult to meet in the U.S. given the willingness of the courts to presume due care under the business judgment rule and the ability to buy director and officer (D & O) insurance. The litigation remedies used to enforce these duties are crude tools. Bad actors can be punished and perhaps deterred from serious disloyalty but the threat of suit does not make the firm more efficient or productive.¹⁴

Consider the inefficiency of legal remedies in the Korean context. The chaebols failed to reform themselves before the late 1997 crisis and resisted the government's subsequent efforts to force reform. There are now comprehensive rules of law concerning the governance of Korea's largest companies, but rules of law are expensive to enforce, especially against stubborn actors. Derivative litigation and government enforcement against a headstrong chairman are not efficient solutions to the governance problem, but there is the possibility of enforcement by the market itself and that has been the cleverest aspect of the new Korean scheme. The chaebols received their capital from banks that complied with government fiat. Now, they must get funds from banks and equity investors in arms-length transactions. The capital providers, particularly foreign institutions and foreign owned banks, seem to care about the governance practices of the chaebols. This sort of enforcement mechanism can be efficient and effective.

GOVERNANCE IN THE U.S.

The suggestions of commentators

A series of articles in the early 1990s in practitioner publications, chiefly *The Business Lawyer* and the *New York Law Journal*, sounded a common theme. There was a decline in the

. . . would have to be significant to justify bearing the transaction costs . . . This fact leaves a margin for management inefficiency." *Id.* But see Millstein & MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1286 n.10 (June 1998)(discussing a study which found that active block investors did have an effect on turnover in top management).

14. See Millstein & MacAvoy, *supra* note 13, at 1294, n.42; John C. Coffee, Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407 (Aug. 1993).

fortunes of large U.S. companies because they lacked the discipline needed to compete in a global economy. Governance mattered because firms needed the best management possible. Too late in the day, the boards at General Motors, Westinghouse, IBM and American Express became change agents and replaced under-performing CEOs. Attention turned to the boards of directors. People asked how boards could be made strong and effective without usurping the role and initiative of the managers to actually operate the corporation.¹⁵ Many articles quoted a speech given by William T. Allen, Chancellor of the Delaware courts:

The conventional perception is that boards should select senior management, create incentive compensation schemes and then step back and watch the organization prosper. In addition, board members should be available to act as advisors to the CEO when called upon and they should be prepared to act during a crisis: an emergency succession problem, threatened insolvency or an MBO proposal, for example.

This view of the responsibilities of membership on the board of directors of a public company is, in my view, badly deficient. It ignores a most basic responsibility: the duty to monitor the performance of senior management in an informed way. Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial and organizational goals of the corporation and should approve plans to achieve those goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.¹⁶

15. See Millstein, *supra* note 4; Lipton & Lorsch, *supra* note 13; Dennis J. Block & Jonathan M. Hoff, *Corporate Governance Reform and Directors' Duty of Care*, N.Y.L.J., May 20, 1993, at 5; Roberta S. Karmel, *Separating the Chairman and the CEO*, N.Y.L.J., June 17, 1993, at 3; Ira M. Millstein, *The Evolution of the Certifying Board*, 48 Bus. Law. 1485 (Aug. 1993).

16. See William T. Allen, *Redefining the Role of Outside Directors in an Age of Global Competition*, Presentation at Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University, Chicago (Apr. 1992).

The speech prefigured Chancellor Allen's later decision in *In re Caremark International*, 698 A.2d 959 (Del. Ch. 1996), which established the duty of the board to put in place "information and reporting systems" designed to monitor "the corporation's compliance with the law and its business performance." *Caremark*, 698 A.2d at 970. See generally, Martin Lipton & Theodore N. Mirvis, *Tribute to Chancellor William T. Allen: Chancellor Allen and the Director*, 22 DEL. J. CORP. L. 927 (1997). These functions may fall within the mission of the audit committee, which may be delegated the responsibility of reviewing the adequacy of the corporation's system of internal controls and of compliance with material policies and laws. Dennis J. Block & Jonathan M. Hoff, *Developing Role of Audit Committees*, N.Y.L.J., Feb. 25, 1999, at 5.

Extending the line of reasoning, commentators wrote that one of the most important board functions was to select, regularly evaluate and if necessary replace the CEO.¹⁷ To this end, the board should be able and willing to ask “discerning questions” of the senior managers.¹⁸ The implicit idea was that such a board would lead to better corporate economic performance,¹⁹ though this has not been empirically established.²⁰ Sackings of CEOs are now familiar if not common: the resignations of Jill Barad of Mattel, Douglas Ivester of Coca-Cola and Eckhard Pfeiffer of Compaq are illustrative.²¹ To effectively monitor and evaluate management, directors ought to be independent of management. It was thought that insiders were unwilling to rock the boat, too submissive to executive officers or otherwise unable to deal at arms length, and that outsiders could be more neutral and objective.²² Indeed, many think that the board should be composed of at least a majority of independent directors.²³

17. See Millstein, *The Evolution of the Certifying Board*, *supra* note 15; Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 924 & n.5 (May 1999); Tobin, *supra* note 4, at 1721; see Eisenberg, *Corporate Governance: The Board of Directors and Internal Control*, *supra* note 4, at 238-39, & nn.5-8; see also COMMITTEE ON CORPORATE LAWS, *Corporate Director's Guidebook - 1994 Edition*, 49 BUS. LAW. 1243, 1249 (May 1994); *Corporate Governance and American Competitiveness: March 1990: Statement of the Business Roundtable*, 46 BUS. LAW. 241 (Nov. 1990), section III.

18. MYLES L. MACE, *DIRECTORS: MYTH and REALITY* 184 (Harvard Univ. 1971).

19. *E.g.*, Block & Hoff, *supra* note 15.

20. It is not clear that independent directors positively correlate to better firm performance. See generally, Bhagat & Black, *supra* note 17; Millstein & MacAvoy, *supra* note 13; April Klein, *Firm Performance and Board Committee Structure*, 41 J. LAW & ECON. 275 (Apr. 1998); Fisch, *supra* note 4; Laura Lin, *The Effectiveness of Outside Directors As a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898 (1996). The empirical evidence is mixed, perhaps because there is no standard definition of independence or firm performance. It seems clear that simply adding independent directors does not make for a better firm. It may be that insiders do a better job of advising management because of their intimate knowledge of the company and its environment. But to fulfill their monitoring and oversight function, particularly on audit, compensation and nominating committees, independent directors may do a better job. Fisch, *supra* note 4; Klein, *supra*.

21. See Michael Skapinker, *How to Bow Out Without Egg on Your Face: Chief Executives Need Not Always Be Remembered for the Failure That Brought Them Down*, FIN. TIMES (London), Mar. 8, 2000, at 21, available in LEXIS, News/By Individual Publication/F Library, FINTME File. More recently, the CEO of Xerox was forced out. See Richard Waters, *Thoman Resigns as Xerox Chief Copiers Board Pressure Leads to CEO's Exit After Recovery Strategy Stumbles*, FIN. TIMES (London), May 12, 2000, at 27, available in LEXIS, News/By Individual Publication/F Library, FINTME File.

22. See Millstein & MacAvoy, *supra* note 13, at 1292 n.33; Tobin, *supra* note 4, at 1722; Smith, *supra* note 1, at n.244.

23. *E.g.*, Tobin, *supra* note 4, at 1737; Pease, *supra* note 4, at 23, 34-37; Smith, *supra* note 1, at 229, 245; *Principles of Corporate Governance: Analysis and Recommendations*, A.L.I. 3A.01 (1994) (“The board of every large publicly held corpora-

Some asked how a board could be a check on a CEO or fairly evaluate a CEO who is also chairman of the board. Shareholder activists pressed for the chairman's office to be filled by an independent non-management director so that board deliberation would not be the prerogative of management. Such a board could evaluate the CEO without conflict and could "certify" to shareholders - especially institutional owners - that the CEO was being regularly evaluated and was doing what the board expected.²⁴ Few corporations have split the chairman and CEO but

tion should have a majority of directors who are free of any significant relationship with the corporation's senior executives."); see also Corporate Director's Guidebook, *supra* note 17, at 1257-58. The quality of independence was described by the Chief Justice of Delaware as "perhaps the most effective stockholder protection device." E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 687 (May 1998). There are many definitions of independence in the United States, and many terms used to express the idea, e.g., "outside" directors, "independent" directors and "non-management" directors. Some are from legal sources, such as the courts of Delaware, the American Law Institute's *Principles of Corporate Governance*, the American Bar Association's *Corporate Director's Guidebook* and the *Listed Company Manual of the New York Stock Exchange*. Other definitions come from business organizations, such as the Business Round Table's Statement on Corporate Governance, *Corporate Governance and American Competitiveness*, 46 BUS. LAW. 241 (Nov. 1990), the Core Policies, Practices and Explanatory Notes of the Council of Institutional Investors or the Report of the Blue Ribbon Commission on Director Professionalism of the National Association of Corporate Directors. Large corporations and institutional investors often have their own guidelines, for an example see the TIAA-CREF Policy Statement on Corporate Governance, <http://www.tiaa-cref.org/libra/governance/index.html> (last modified Mar. 2000). Some of the definitions are brief and state the general principle that a director should be free from any relationship that would interfere with the exercise of independent judgment. Other definitions set forth a detailed list of disqualifying relationships between a director and the corporation or its senior management. For example, the Delaware courts variously define independence as "the care, attention and sense of individual responsibility to one's duties," *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984), as the characteristic of not being "dominated or controlled" by another, e.g., the chairman, *Growbow v. Perot*, 539 A.2d 180, 189 (Del. 1988), and as when "a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Unitrin v. American General Corp.*, 651 A.2d 1361, 1375 (Del. 1995) Such influences include personal relationships the director has with management or a controlling stockholder or other material financial relationships the director has with the corporation. *Id.* (defining an "outside director" as a "non-employee and non-management director"). The ALI *Principles of Corporate Governance* define independence as the absence of any significant relationship with the corporation or its senior executives. A significant relationship includes current employment, former employment within the last two years, a family relationship and various business relationships. *Principles of Corporate Governance: Analysis and Recommendations*, A.L.I. 3A.01 (1994); see also, Millstein & MacAvoy, *supra* note 13, at 1292 n.34; Tobin, *supra* note 4, at 1749; Roberta S. Karmel, *Mandated Independent Audit Committees*, N.Y.L.J., June 17, 1999, at 3; Pease, *supra* note 4, at 29-30 (collecting definitions of independence).

24. See Karmel, *supra* note 15; Lipton & Lorsch, *supra* note 13; Millstein, *The Evolution of the Certifying Board*, *supra* note 15; Tobin, *supra* note 4, at 1732-33.

some have created a leader of the independent directors.²⁵ Periodic meetings of the outside directors without management present were also suggested.²⁶

Additional reasons were offered to explain why boards had not fulfilled their oversight mission. Boards lacked sufficient time for adequate meetings given the complexity of matters on the agenda, they were too big for productive discussion, they were not a cohesive group and members did not feel able to speak freely at meetings so there was not an open exchange of ideas. Commentators proposed a smaller board, more frequent meetings of sufficient duration, and improved information flow to the board.²⁷ For a board to participate in setting strategic goals and evaluating the CEO, its members must have adequate knowledge of the firm, its competitors, its markets and the competitive environment generally. But if independent directors are preferred to those with ties to the corporation or its senior management so that conflicts of interest are avoided, how can they know enough to be able to fulfill their mission? Oversight committees composed of independent directors depend on management for information. They must be given sufficient information in an organized and useable form.²⁸ The directors must be capable and professional, and have the time, dedication and ability to digest the information.²⁹

Some proposed informal meetings with the largest shareholders³⁰ because it was "imperative for boards and management to facilitate appropriate communication with institutional shareholders."³¹ That fit well with what the largest pension funds wanted. The California Public Employees' Retirement System (CalPERS) and the Teachers Insurance and Annuity Association – College Retirement Equities Fund (TIAA-CREF), two of the largest U.S. institutional investors, publish their own principles of corporate governance.³² The chief concern of the CalPERS prin-

25. See Millstein & MacAvoy, *supra* note 13, at 1287 n.18.

26. See Bhagat & Black, *supra* note 17, at 955; Millstein & MacAvoy, *supra* note 13, at 1299-1302.

27. See Lipton & Lorsch, *supra* note 13; see also Lipton & Mirvis, *supra* note 16, at 936 (quoting Chancellor Allen as saying, "effective, sympathetic monitoring requires a commitment of time and resources, especially information"); Millstein, *supra* note 4, at 1429 ("[D]irectorship is no longer an honorarium. There is no longer any room for directors with prestigious backgrounds and titles but who lack the capacity, energy, or interest to engage fully in boardroom deliberations.").

28. See Millstein, *supra* note 4; Block & Hoff *supra* note 15, at text accompanying n.20; Lipton & Lorsch, *supra* note 13, at 43-45.

29. E.g., Koppes, et al., *The Debate*, *supra* note 12, at 1054 & n.165.

30. See Lipton & Lorsch, *supra* note 13.

31. Block & Hoff, *supra* note 12.

32. See CalPERS Corporate Governance Core Principles & Guidelines, <http://www.calpers-governance.org/principles/default.asp> (last visited Dec. 19, 2000); TIAA-

ciples is an independent board of directors – a feature that is central to nearly all discussions of corporate governance. CALPERS also seeks “to influence corporate managers.” It began focusing on meetings with outside directors in 1992.³³ Similarly, TIAA-CREF offers its policy statement “as a basis for dialogue with senior corporate management;” it seeks an explicit mechanism for major shareholders to communicate directly with the board of directors.³⁴ A June 2000 investor opinion survey conducted by McKinsey & Company found that board practices are as important as financial performance to three-fourths of the surveyed investors, and that over 80% of investors would pay more for shares of a well-governed company than for those of a poorly governed company with similar financial performance.³⁵

Institutional investors asked for meaningful oversight by an independent board not dominated by the CEO, specifically board committees that included non-management directors.³⁶ The establishment of audit, nominating and compensation committees composed of independent directors was recommended as being key to accountability.³⁷ An audit committee recommends the appointment of the public accountants and works directly with them to make certain that the company’s published financial statements are fairly presented, that they are in accordance with generally accepted accounting principles, and that the company’s control system is effective. It has an oversight role in preventing and detecting fraudulent financial reporting.³⁸ The compensation committee reviews and recommends compensation levels for top executives,³⁹ and the nominating committee devel-

CREF Policy Statement on Corporate Governance, <http://www4.tiaa-cref.org/libra/governance/index.html> (last modified Mar. 2000). See also Koppes, et al. *The Debate*, *supra* note 12, at 1039-40 & n.86.

33. See Tobin, *supra* note 4, at 1734 & n.174.

34. TIAA-CREF Policy Statement on Corporate Governance, *supra* note 32.

35. See Investor Opinion Survey, http://www.mckinsey.com/features/investor_opinion/index.html (last visited Nov. 22, 2000).

36. See Block & Hoff, *supra* note 12, text accompanying n.9; see also Tobin, *supra* note 4, at 1722.

37. See Karmel, *supra* note 15; Block & Hoff, *supra* note 15; Tobin, *supra* note 4, at 1737 & n.194, 1751 & n.262; Scott V. Simpson, *The Emerging Role of the Special Committee*, 43 BUS. LAW. 665, 665 (Feb. 1988); Pease, *supra* note 4, at 21, 24.

38. See, e.g., Leonard P. Novello, *Audit Committee Comes of Age*, N.Y.L.J., Dec. 14, 1989.

39. SEC and IRS rules effectively require that the compensation committee be composed of independent directors. See Karmel, *supra* note 23. It is not clear that compensation committees have been effective. TIAA-CREF recently criticized “clearly excessive cash pay” as evidence of “weakness and the need for fresh perspective at the board level.” Daniel Bogler, *Executive Pay Increases Come Under Attack*, FIN. TIMES (London), Mar. 14, 2000, at 15, available in LEXIS, News/By Individual Publication/F Library, FINTME File.

ops criteria for board membership and identifies suitable candidates.⁴⁰

Audit committees are required by the New York Stock Exchange, the American Stock Exchange, and NASDAQ for their constituent companies, for example.⁴¹ There has been a good deal of recent activity concerning audit committees, spurred by the February 1999 Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. In late December 1999, the NYSE, AMEX, NASD, and the SEC adopted new rules intended to improve the reliability and credibility of financial statements released by public companies.⁴² Among other things, the exchanges and NASDAQ now require audit committees to be composed of at least three members and that all members be independent directors who are financially literate. The SEC required heightened disclosure of audit committee activities as a means of ensuring more reliable financial statements. For example, companies must disclose in their annual meeting proxy statements whether the audit committee members are "independent" as defined in the applicable listing standard.

Corporate Codes

Many large companies drew up their own governance codes, following the notable lead of General Motors in 1994. They were adopted in response to investor pressure to improve board functioning.⁴³ These codes tend to deal with matters such as:

40. Board members who are nominated by chief executives may be reluctant to actively monitor corporate activity because they are "economically or psychologically dependent upon or tied to the corporation's executives." EISENBERG, *THE STRUCTURE OF THE CORPORATION*, *supra* note 4, at 145. Nominating committees may not have overcome the basic reality that social connections determine who fills a board seat. Bhagat & Black, *supra* note 17, at 956. "Independent directors often turn out to be lapdogs rather than watch dogs." *Id.* at 922.

41. Various other laws also require audit committees. See Simpson, *supra* note 36, at 665-66. Notably, the Foreign Corrupt Practices Act added section 13(b)(2) of the Securities Exchange Act and requires each reporting corporation to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles. . . ." L. Loss & J. Seligman, *SECURITIES REGULATION* 2D.3.c. 1995. This section effectively mandates an audit committee for companies governed by the Securities Exchange Act of 1934.

42. See, e.g., Michael G. Marks, et al., *SEC Adopts Audit Committee Rules Based on Blue Ribbon Panel's Recommendations*, METROPOLITAN CORP. COUNS., Feb. 2000, at 5; Lois Herzeca, *Audit Committee Rules Effective*, N.Y.L.J., Feb. 7, 2000, at 9.

43. See Henry Lesser & Matthew M. Gosling, *Boards Adopt Governance Guidelines*, NAT'L L. J., June 28, 1999, at B6; Henry Lesser, et al., *Formulating Governance*

- board size
- independence of directors (most define board independence and agree that a majority of directors should be independent)⁴⁴
- separation of the CEO and chairman and the use of a lead independent director (but most reject separation and ignore or reject the lead independent director issue)
- number of meetings
- board selection and self-evaluation⁴⁵
- management oversight
- director stock ownership (encouraged)
- committee structure (audit, nomination, and compensation are common)
- access to information.

Delaware Courts

The Delaware courts also played a role in the governance discussion, telling boards how to act if their decisions were to be given deference under the business judgment rule.⁴⁶ Board decisions had to be independent and thoughtful, the product of diligent inquiry and with factual basis.⁴⁷ In the immediate context, this means that boards should be informed of corporate performance and should be independent of management so that they can

Standards, NAT. L. J., June 22, 1998, at B9; Richard H. Koppes, et al., *Board Guidelines: One Size Won't Fit All*, METROPOLITAN CORP. COUNS. Jan. 1998, at 14.

44. In fact, "for most large, publicly traded corporations, a majority of directors are not members of management." Millstein & MacAvoy, *supra* note 13, at 1288 & n.14; *see also*, Bhagat & Black, *supra* note 17, at 921.

45. Executive sessions of independent directors, separate from management, are used to evaluate management. Millstein & MacAvoy, *supra* note 10, at 1287 & n.17.

46. The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors. It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Only disinterested directors can claim its protections. This means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally. Second, to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Aronson v. Lewis, 473 A.2d 805 (Del. 1984). The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves prior to making a business decision, of all material information reasonably available to them. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). Directors will not be protected by the business judgment rule when making a business decision if they have a personal financial interest in the decision or if they do not act independently, i.e., free of domination or any motive except the merits of the corporate transaction. E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus. Law. 393 (Feb. 1997).

47. *See* Millstein, *The Evolution of the Certifying Board*, *supra* note 15, at 1490 & n.11.

press for change if warranted. The trend towards using independent directors is based partly upon the deference that courts give to decision-makers who are capable of making an impartial business decision.⁴⁸

So, several points consistently feature in the U.S. literature:

- Boards should be composed of at least a majority of independent directors (though the definition of independence varies),
- boards should monitor and evaluate the CEO and senior management,
- directors should be informed, should be prepared to ask difficult questions and to have open discussion, and
- boards should have independent audit, nominating and compensation committees.

Let us now turn to the history of Korea's great enterprises, the chaebols, and their peculiar governance structure and their role in the 1997 financial crisis. We will begin to understand why governance reform is now the rage in Korea.

GOVERNANCE IN KOREA

Korea, Park and the Chaebols

When the Korean War ended in 1953, the south was a land of peasant farmers with an income per head of \$450 (in 1987 dollars). By 1962, Korea's GNP per head had dropped to \$100 or lower.⁴⁹ In the mid-1960s, South Korea began to industrialize in earnest. Rapid development brought South Korea's per capita

48. See Grover C. Brown, et al., *Director and Advisor Disinterestedness and Independence Under Delaware Law*, 23 DEL. J. CORP. L. 1157, 1157-58 (1998).

49. For general background on Korea's economic development and the rise of the chaebols, on which these paragraphs are based, see Craig P. Ehrlich & Jay K. Lee, *Governance of Korea's Chaebols: Role in Crisis, Coming Changes*, E. ASIAN EXEC. REP., Mar. 15, 1998 at 9, available in Westlaw, 20 No. 3 EAXREP 9; Ehrlich and Kang, *Corporate Governance Reform: The Remaining Issues*, E. ASIAN EXEC. REP., Jan. 15, 1999 at 11, available in Westlaw, 21 No. 1 EAXREP 11; two business school case studies, HARVARD BUSINESS SCHOOL, *State and Markets in South Korea* (Aug. 1995); CASCADE CTR. UNIV. OF WASH., *Political Economy of Heavy Industrialization: Pohang Iron and Steel Co. Ltd. in South Korea* (1998); ECONOMIST INTELLIGENCE UNIT, COUNTRY REPORT, SOUTH KOREA, 1ST QUARTER 2000 (2000); ECONOMIST INTELLIGENCE UNIT, COUNTRY PROFILE, SOUTH KOREA, 1999-2000 (1999); *Quick, Quick, Quick*, ECONOMIST, June 3, 1995 at 3, available in 1995 WL 9569304; BUREAU OF EAST ASIAN & PACIFIC AFFAIRS, U.S. DEP'T OF STATE, BACKGROUND NOTES: SOUTH KOREA (October 1998); *South Korea's Miracle*, ECONOMIST, Mar. 4, 1989, at 77; Christopher Lockwood, *Stand Tall, A Man Made Miracle*, ECONOMIST, May 21, 1988 at 15; *Anything Japan Can Do*, ECONOMIST, Feb. 20, 1988, at 19; Anatole Kaletsky, *Far from the Ideal Free Market Model*, FIN. TIMES (London), May 15, 1985, at 2, available in LEXIS, News/By Individual Publication/F Library, FINTME File; Anatole Kaletsky, *A Success Story Which Defies the Textbooks: Korea's Economic 'Miracle'*, FIN. TIMES (London), July 19, 1985, at 16, available in LEXIS, News/By Individual Publication/F Library, FINTME File.

GNP to \$2,900 by the end of the 1980s. Until the crisis of late 1997, Korea was ranked as the 11th largest economy in the world. Per capita GNP exceeded \$10,000 in 1997.

Industrialization began with Park, Chung Hee, who ran the country from his military coup d'état of 1961 to his assassination in 1979. After assuming power, Park's government undertook a series of economic reforms including the creation of the Economic Planning Board and the implementation of Five-Year Economic Plans. The government has since been highly interventionist in Korea's economic policy and the chaebols (large business groups) have usually been amenable to government direction, although they have recently resisted efforts to curb their size and power.

The nation's successful industrial growth program began in the early 1960s, when the Park government emphasized exports from labor-intensive light industries such as textiles. In the 1970s Korea began promoting heavy industries as well as consumer electronics and automobiles. Park feared the withdrawal of U.S. forces from the peninsula and moved to promote defense and chemical industries so that Korea could stand alone if necessary. His goal was to attain one hundred percent domestic production of weapons except for nuclear arms and aircraft by the end of 1980. Park granted the chaebols entries into electronics, machinery, petrochemicals, shipbuilding and automobile manufacturing. These are all businesses with large-scale economies, so the policy of targeting heavy industry brought a bias towards bigness. Korea had a strict foreign exchange control regime until the mid 1990s and the Korean banks were the main suppliers of capital. The government borrowed heavily overseas and invested the proceeds in export industries by directing the banks to extend bargain rate "policy loans" to favored chaebols. Preferential treatment in terms of tariffs and tax benefits was also extended to chaebols.⁵⁰

Korea's industry is and has been extraordinarily concentrated. The story is in the numbers. Nine of the chaebols accounted for more than half of Korea's exports in 1985. The five largest conglomerates accounted for 22% of all manufacturing sales, the top ten for about one-third in 1988. In 1995, the top thirty chaebols produced 16% of South Korea's GNP and 50% of exports. The top four groups in 1995 – Hyundai, Samsung, Daewoo and LG – produced 9% of GDP.⁵¹ The concentration is

50. See REPUBLIC OF KOREA MINISTRY OF FINANCE AND ECONOMY, *PROGRESS IN KOREA'S CORPORATE REFORM: Q & As* (Sept. 1999).

51. See ECONOMIST INTELLIGENCE UNIT, *COUNTRY REPORT, SOUTH KOREA, 1ST QUARTER 2000* (2000); ECONOMIST INTELLIGENCE UNIT, *COUNTRY PROFILE*,

more evident in the manufacturing sector, where the top five in 1998 – Hyundai, Samsung, Daewoo, LG and SK – accounted for about 25% of manufacturing shipments and the top thirty about 40% of these shipments.⁵² The share of GNP of the top thirty chaebols declined in 1998 for the third consecutive year, to 12%. Their share of the country's exports in the same year rose, however, to 71.4%, up from 69.9% in 1997. The five largest accounted for 54.4% of 1998 exports.⁵³

The thirty largest chaebols had total assets in excess of 470 trillion Won at the end of 1998, up 8.6% from the prior year, and combined sales of 435 trillion Won, up 7.1% from 1997. But if the top line grew, the bottom line was anemic. The top thirty had a combined net loss of 15.5 trillion Won in 1998, compared with a 3.2 trillion Won loss the year earlier. The five largest chaebols, Hyundai, Daewoo, Samsung, LG and SK, held almost 66% of all assets owned by the top thirty groups at the end of 1998, and almost 75% of their sales.⁵⁴ Concentration at the very top continued into 1999. The combined assets of the top four (Daewoo having disappeared, Hyundai, Samsung, LG and SK remaining) increased almost 5% to more than 243 trillion Won.⁵⁵

So, a central aspect of Korea's industrial policy has been the growth of the vast industrial holding companies known as chaebols, a large grouping of corporations, under family control, with a pattern of unrelated diversification. Most were established after the Korean War. By 1999, the four largest in market capitalization were Hyundai, Samsung, LG and SK.⁵⁶ The chaebols can be compared to some extent to Japan's *keiretsu* system.⁵⁷ Unlike their Japanese counterparts, however, the chaebols do not include banks as members of the group, al-

SOUTH KOREA, 1999-2000 (1999); *Chaebol's Share of Economy Falls Off*, KOREA HERALD, Dec. 13, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

52. See Edward M. Graham, *Corporate Sector Restructuring*, KOREA ECONOMIC INSTITUTE OF AMERICA 32-38 (1999), at <http://www.keia.com/economy99.pdf>.

53. See ECONOMIST INTELLIGENCE UNIT, COUNTRY REPORT, SOUTH KOREA, 1ST QUARTER 2000 (2000); ECONOMIST INTELLIGENCE UNIT, COUNTRY PROFILE, SOUTH KOREA, 1999-2000 (1999); *Chaebol's Share of Economy Falls Off*, *supra* note 50.

54. See ECONOMIST INTELLIGENCE UNIT, *Investing, Licensing & Trading in South Korea*, in COUNTRY ANALYSIS, SOUTH KOREA 27 (July 1998) [hereinafter *Investing, Licensing & Trading*].

55. See *Seven Group Enter List of Top 30 Chaebol*, KOREA HERALD, Apr. 17, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

56. See *Chaebol's Share of Economy Falls Off*, *supra* note 50.

57. See e.g., Jean-Pierre Lehman, *Conglomerates in Korea Offer a Different Business Environment*, KOREA ECON. DAILY, Sept. 24, 1996.

though there is movement to change existing law to permit this.⁵⁸ Another difference is that the chaebols' businesses are very diversified, whereas the Japanese groups have tended to concentrate on core businesses. Chaebol companies tend to be heavily indebted, with effective control in the hands of the founding family. The two points are related. The owner/managers have been reluctant to rely on equity finance that would reduce their control.⁵⁹

Affiliates

The constituent companies within a chaebol engage in all fields of business, from memory chips to automobiles, textiles to aircraft, construction to insurance and stockbroking. The top thirty chaebols had 668 affiliates in May 1999, down from a peak of over 800 firms at the end of 1997.⁶⁰ This follows the shedding of some units, by sale, merger or liquidation, at the urging of the government to restructure. The chaebols still have more affiliates than they did in 1994, though, when the top thirty had 606 affiliated companies.⁶¹ The top five chaebols promised in late 1998 to shed 134 subsidiaries, more than half of their subsidiaries.⁶² It is unclear whether the chaebols have in fact slimmed down. The top thirty are reported to have "spun off" 366 firms in 1998 and 185 firms in 1999 but this may mean only that operating divisions are now subsidiaries, with control still in old hands.⁶³ Hyundai, for example, announced in mid-1999 that it would cut its subsidiaries from seventy-nine to twenty-six, but only closed

58. The Monopoly Regulation and Fair Trade Act currently limits ownership of bank shares to four percent. If the ceiling is lifted, chaebols will be able to make greater investment in banks and (it is hoped) improve the capital structure of the banks. *Seoul Pushing for Law on Financial Holding Companies*, KOREA HERALD, Jan. 5, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

59. See Oh-Seok Hyun, *Korea's Corporate Governance System: Under the Remedies* <http://www.oecd.org/daf/corporate-affairs/governance/roundtables/in-Asia/1999/> (last visited Dec. 5, 2000).

60. See *Affiliates of Top 30 Chaebol Numbered at 668*, KOREA HERALD, June 2, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; Graham, *supra* note 51.

61. See Ehrlich & Lee, *supra* note 48, at 16.

62. See Craig P. Ehrlich & J. T. Mann, *Taking Account in South Korea: What Potential Buyers Need to Know About M & A in the Hermit Kingdom*, E. ASIAN EXECUTIVE REP., Aug. 15, 1998, at 9, text accompanying n.5, available in Westlaw at 20 No. 8 EAXREP 9.

63. See *Top 30 Chaebol Spin Off 484 Firms Since 1998*, KOREA HERALD, Oct. 20, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Top 30 Groups Spin off 185 Units Last Year*, KOREA HERALD, Feb. 24, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

four and sold eight.⁶⁴ Though the numbers vary, another report claimed that the top thirty shed 142 units in 1999, with 544 remaining.⁶⁵

Ownership

Though the chaebols are enormous, domination by the founder and his family is one of their most striking features.⁶⁶ The ownership concentration data are neither clear nor wholly consistent but a common theme is presented. The major shareholder owned, on average, 33% of the listed constituent firms as of October 1997.⁶⁷ For the top ten chaebols, 35% of the shares, on average, were "internally controlled" in August 1999.⁶⁸ Personal holdings by the largest shareholder may be only about 10%. Cross shareholdings by affiliated firms, that own an additional 30% of shares, enables the largest shareholder to control the firms.⁶⁹ A report in the *Korea Herald* newspaper estimated the personal stake of the chairman even lower, at around 5%, "(b)ut with this minority stake they have been wielding a disproportionately large power. The mechanism that allows them to exercise undue power is the web of equity investments intertwining the group firms."⁷⁰ A third analyst estimated that in 1993-94, the average ownership interest of founding families in the top thirty chaebols was around 45%.⁷¹ A fourth analyst believes that family and cross ownership by subsidiaries totaled more than 40% for the top thirty chaebols.⁷² The highest estimate was that

64. See *Nation-builders*, ECONOMIST, July 10, 1999 at 6, available in 1999 WL 7363753.

65. See Cheorgomo Yoog, *Seven Groups Enter the List of Top 30 Chaebol: Concentration of Economic Power in Big Four Deepens*, KOREA HERALD, Apr. 17, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

66. See Lehman, *supra* note 56.

67. See Hwa Jin Kim, *Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea*, 17 BERK. J. INT'L LAW 61, 64 n.8 (1999).

68. E-mail from Prof. Jang, Hasung of Korea University, to Craig Ehrlich, Assistant Professor, Babson College, 2 (Nov. 21, 1999) (on file with Craig Ehrlich)

69. See Il Chong Nam et al., *Corporate Governance in Korea*, <http://www.oecd.org/daf/corporate-affairs/governance/roundtables/in-Asia/1999/> (last visited Dec. 5, 2000).

70. See *Chaebol Chairmen's Absolute Power Still Unchallenged Despite Reform Drive*, KOREA HERALD, Jan. 22, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

71. See Ki Su Lee, Professor at Korea University, Presentation at East Asian Legal Studies Center, University of Wisconsin at Madison (Jan. 1998).

72. See Danny Leipziger, *Public and Private Interests in Korea: Views on Moral Hazard and Crisis Resolution*, Presentation at the 4th APEC Roundtable at the Asia Pacific Center of Brandeis University, at <http://www.brandeis.edu/global/research/leipziger.html> (May 1998). Another writer has put the ownership figure at twice this. "A newspaper survey in 1989 reported that 60 percent of the founding genera-

founding families own 60% of the equity in the top thirty chaebols.⁷³

An example is reported in the *Journal of Finance*. The data are not current but they show the pattern. Lee, Kun-Hee, the son of Samsung's founder and the current group chairman, controls 8.3% of Samsung Electronics directly. But he also controls 15% of Samsung Life, which controls 8.7% of Samsung Electronics, as well as 14.1% of Cheil Jedang, which controls 3.2% of Samsung Electronics directly and 11.5% of Samsung Life. Lee, Kun-Hee has additional indirect stakes in Samsung Electronics as well.⁷⁴

This may refer to stakes held by members of Lee's family.

Owners increased their cross shareholdings after the 1997 crisis, at the same time that the government was trying to reduce the management power of the founding families.⁷⁵ The personal stakes of the top ten chaebol chairmen dropped from 3.22% on January 1, 1999 to 2.82% by the end of August 1999. But, group firms' stakes in sister firms increased from 19.9% to 28.73%. As a result, the "internal shareholdings" – including the stakes owned by the chairmen, their relatives and group firms – rose from 27.23% to 34.60%. The numbers vary with the source, but the theme is consistent. Another report states that the inside ownership ratio of the top thirty groups increased from 44.5% at the end of 1998 to 50.5% in April 1999.⁷⁶ Their grasp continued to tighten throughout 1999 and early 2000. From March 1999 to March 2000, the number of shares held by the chairmen of the top ten groups (with the exception of Daewoo) rose 28%.⁷⁷

Leverage

As the government traditionally directed bank loans to favored chaebols, they were highly leveraged. The top thirty

tion leaders of the top business groups own 80 percent or more of their companies' stocks." BRUCE CUMINGS, *KOREA'S PLACE IN THE SUN* 327 (1997).

73. See *Quick, Quick, Quick*, *supra* note 48, at 12.

74. La Porta et al., *Corporate Ownership Around the World*, 54 J. of Fin. 471 (Apr. 1, 1999).

75. See John Burton, *The Empires Strike Back: The Chaebol*, FIN. TIMES (London), Oct. 20, 1999, at 3, available in LEXIS, News/By Individual Publication/F Library, FINTME File; *Chaebol Chairmen's Grip Solidifies*, KOREA HERALD, Sept. 14, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; Joongi Kim, *Recent Amendments to the Korean Commercial Code and Their Effects on International Competition*, 21 U. PA. J. INT'L ECON. L. 273, 285 n.46 (2000).

76. See *Additional Measures for Chaebol Reforms*, KOREA ECON. WKLY., Sept. 6, 1999.

77. See *Stockholding of Chaebol Owners Increase Drastically by 46 Pct*, KOREA TIMES, Mar. 16, 2000, available in LEXIS, News/By Country & Region/Asia & Pacific Rim Library, KTIMES File.

chaebols had an average debt equity ratio of 519% at the end of 1997, some five times the ratio in the United States.⁷⁸ That dropped to 335% at year-end 1998.⁷⁹ The top five were not quite as lean, with a 386% ratio at the end of 1998.⁸⁰ By mid-1999, the debt level had improved at the top five chaebols. Samsung, LG and SK had debt equity ratios between 200% and 250%, still higher than in other industrialized nations, and Daewoo and Hyundai were at 590% and 340% respectively.⁸¹ The worst case was clearly Daewoo, with combined group debts of between \$60 billion and \$75 billion.⁸²

Government policy was not the only reason for the easy access to credit. The relationship between the banks and the chaebols was usually corrupt. Credit was extended on the basis of bribes as well as fiat, if not risk analysis. This is a well known if little documented fact. For a prominent example, see the discussion of the First Bank derivative litigation, *infra* pp. 35-37. The triangular relationship among the government, the banks and the chaebols was heavily greased by chaebol money, as evidenced by the fairly regular corruption scandals that have plagued every administration in recent memory.

Remarkably, by the end of 1999 the top four chaebols (Daewoo having self-destructed) had apparently reduced their debt equity ratios to below 200%, a goal mandated by the government.⁸³ The ratios for the top thirty also fell, from 363% at

78. See Ehrlich & LEE, *supra* note 48, at text accompanying n.4; Ehrlich & Kang, *supra* note 48, at text accompanying n.11; Kim, *supra* note 66, at 64 text accompanying n.11; Republic of Korea Ministry of Finance and Economy, *Korea's Economy Reinvented*, June 12, 1998 <http://dragon.kiep.go.kr/IMF/hot-2-16.html> (last visited Jan. 6, 2001) ("The average debt equity ratio of the 30 largest business groups rose sharply to 518.9% by the end of 1997, up from 386.5% in 1996."); Ehrlich & Mann, *supra* note 61, at text accompanying n.22; *Investing, Licensing & Trading*, *supra* note 53, at 26.

79. See *Investing, Licensing & Trading*, *supra* note 53, at 27.

80. See *Korea to Raise Chaebol Ownership/Governance Checks*, REUTERS ENGLISH NEWS SERV., Aug. 25, 1999 (on file with author).

81. See Danny M. Leipziger, *Korea Has Yet to Separate Corporate Management from Ownership in Reform*, KOREA HERALD, Nov. 3, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. Mr. Leipziger is a World Bank official.

82. See John Burton, *Probe into Daewoo's Accounts*, FIN. TIMES (London), Dec. 10, 1999, at 12, available in LEXIS, News/By Individual Publication/F Library, FINTIME File; *The Man Who Tamed Daewoo's Creditors*, BUS. WK. INT'L ED., Feb. 14, 2000. The level of debt is staggering but the real story was Daewoo's opaque book keeping and possibly fraudulent failure to disclose its true financial condition to the government and creditors.

83. See *Top 4 Chaebols Achieve Mandated 200 Percent Debt-Equity Ratio*, KOREA ECON. WKLY., Apr. 17, 2000, available in LEXIS, News/By Individual Publication/K Library, KECOWK File.

the end of 1998 to 164% at the end of 1999.⁸⁴ It is not clear that the groups sold assets to pay down debt. Hyundai, for example, issued more stock and bought new shares in affiliates.⁸⁵

The chairman

The concentrated ownership of chaebol firms has permitted the dominant shareholding families to make key decisions on their own.⁸⁶ The point appears repeatedly in the literature. Management culture within the chaebols is “authoritarian,” so that a free exchange of ideas is not possible.⁸⁷ The Ministry of Finance and Economy describes the management structure as a “one-person decision making system of chaebol heads.”⁸⁸ The group chairman ruled the chaebol in a “dogmatic and authoritarian” style.⁸⁹ He dictated corporate policy and his decisions went unchallenged.⁹⁰ Many of the government’s reforms were aimed

84. See *Seven Groups Enter List of Top 30 Chaebol: Concentration of Economic Power in Big Four Deepens*, KOREA HERALD, Apr. 17, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

85. See John Burton, *Founder’s Iron Grip Seen as Obstacle to Hyundai Reform: Creditors Do Not Share Public’s Opinion of Group Patriarch*, FIN. TIMES, May 29, 2000, at 22; *Hyundai’s Fix*, BUS. WK., June 12, 2000.

86. See Nam et al., *supra* note 68.

87. See John Burton, *Economic Squeeze Calls for Change: Occupying Vulnerable Middle Ground Between High-Tech Japan and Low-Wage China, the Country Needs to Establish a New Industrial Model to Secure Its Role as a Regional Economic Power*, FIN. TIMES (London), Oct. 20, 1999, available in LEXIS, News/By Individual Publication/F Library, FINTME File.

88. Ministry of Finance and Economy, *Progress in Korea’s Corporate Reform: Q & As*, reprinted in KOREA ECON. WKLY, Oct. 11, 1999, available in LEXIS, News/By Individual Publication/K Library, KECOWK File. The same point is made in *Corporate Governance in Korea: Where Do We Go from Here?*, KOREA HERALD, July 21, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File (“From the start, management was dominated by a single corporate chieftain, often the founder”). The writer, Mr. Joon Gi Kim, is a professor at the Graduate School of International Studies at Yonsei University.

89. Sang Woo Nam, *Overview of the Korean Economy: Its Success and the Crisis*, <http://www.kdischool.ac.kr/vod/overview.html> (1998) (on file with author). Mr. Nam is a professor at the Korea Development Institute School of International Policy and Management. Another analyst expressed the thought this way: “These corporate failures reflected the excessive dependence of chaebol firms on borrowing as well as the strong tendency of the chaebols to diversify their businesses recklessly with borrowed funds. . . . These practices in turn were an outcome of two structural problems of the Korean economy – one, the absence of an effective system of corporate governance and two, the backwardness of the banking sector. A unique characteristic of chaebols is the domination of management decisions by one man or his family, which is extraordinary in view of the complexity of chaebol operations. . . .” Soogil Young, *The Korean Economy at a Crossroads*, Presentation at the Graduate School of International Economics and Finance at Brandeis University, available at <http://www.brandeis.edu/global/research/young.htm>.

90. See Kim, *supra* note 74, at 278; Jongryn Moon & Chung-in Moon, *Democracy and the Origins of the 1997 Korean Economic Crisis*, <http://www.nyu.edu/global>

at him. The Minister of Finance and Economy said in an August 30, 1999 press interview that

chaebol owners hold no more than 5% stakes, but they exercise unlimited authority. The Aug. 25 measures [to expand the number of outside directors on the board, to re-introduce limits on investments in affiliates, etc.] are to address this problem Changing group-wide management is to ensure that chaebols don't expand into non-profitable businesses, dominate those business areas that are already being run by smaller firms and to check owners' random decision making.⁹¹

The chairman chose board candidates from among his friends and loyal employees, and the board did what the chairman wanted.⁹² There is a cultural element at work. "Most Korean organizations, due to Confucian influence, employ a top-down decision making process. As seniors and elders are to be respected without question, it would be difficult for staff members to challenge a CEO's decision."⁹³ Confucianism permeates all aspects of Korean society. It describes the ideal moral character, stressing righteousness and filial piety, especially between father and son and elder and younger brother. Confucius concluded that "being good as a son and obedient as a young man is, perhaps, the root of a man's character."⁹⁴ The point can hardly be overstated. What exactly is a director supposed to do in such an environment? Ask hard questions? Candidly evaluate the CEO? That seems very unlikely. An early and good guide to Korean culture, written for Westerners, observed:

In direct personal contacts between individuals, however, one is often considered a barbarian or an evil person if he persists in upsetting his superior by pointing out the cold facts, or by insisting on blunt truth and literal performance. Such a person is a disturber of the peace, and thus almost a public enemy. In personal relationships, it would often seem that appearance is more important than substance.⁹⁵

It is popularly suspected that the chairmen personally make key appointments, such as CEO, without due consideration by

beat/asia/moon031898.html (last visited Dec. 19, 2000). The authors are professors at Yonsei University.

91. *Min. Kang's Interview with Dong A Ilbo: Chaebols' Resistance Will be Dealt Through Legal Approach*, MINISTRY OF FINANCE & ECONOMY, Aug. 30, 1999 http://www.mofe.go.kr/mofe/eng/e_speeches/html/e_sp1999083101.htm (last visited Dec. 19, 2000) [hereinafter *Min. Kang's Interview*].

92. See Kim, *supra* note 74, at 280.

93. *What Took You So Long, Chairman*, KOREA HERALD, Nov. 8, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. The author, Mr. Yu Kyung Kim, is an official at the Korea Stock Exchange.

94. CONFUCIUS, *THE ANALECTS* 18 (D.C. Lau trans., Penguin Books 1979).

95. PAUL S. CRANE, *KOREAN PATTERNS* 10 (1967).

the board.⁹⁶ It happened in spectacular fashion when Hyundai's founder peremptorily "appointed" one of his sons to succeed him as group chairman, an office that other chaebols have recently abolished.⁹⁷ Hence, a World Bank analyst concluded "the key reform which has yet to emerge is the separation of ownership from corporate management, and the reorientation of firms to maximize shareholder value."⁹⁸ The Korean reformers ask, "If the manager is himself a controlling shareholder, who can fire him?" and so they seek professional managers, that very separation of ownership from management which has occupied U.S. writers for decades.⁹⁹ But why wasn't the chairman a good "corporate cop" with the clout and incentive to police self-interested managers? That is a Western view of the problem and it is the wrong question. Korea's problem wasn't with the managers. It was the chairman himself, who saw the group as his personal fiefdom. A classic example is the North Korea adventures of Hyundai's chairman, Chung Ju Young, who organized a loss making cattle drive and tourist cruises to his homeland:

The Hyundai Group has so far sent the North \$150 million in fees for the Mt. Kumgang tour, not to mention the 1,001 heads of cattle and the fleet of sedans taken personally to the North by the group's founder Chung Ju-yung. The native North Korean tycoon's personal ambition has generated the whole range of inter-Korean projects, which have so far caused the conglomerate to accumulate huge deficits, though they also brought about significant invisible gains in the form of international recognition.¹⁰⁰

The "chairman's office" is one technique used by the founder's family to hold the chaebol together. The office, also known as the executive council or the strategic planning board (or more recently as the restructuring office), consisted of as many as 100 people and it coordinated the business of the group

96. See Hyun-Chul Kim, *Chaebol Chairmen's Absolute Power Still Unchallenged Despite Reform Drive*, KOREA HERALD, Jan. 22, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

97. See *Government to Step Up Efforts to Improve Corporate Governance*, KOREA HERALD, Mar. 28, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Mong-hun Crowned as Hyundai's Heir*, KOREA TIMES, Mar. 27, 2000, available in LEXIS, News/By Country & Region/Asia & Pacific Rim Library, KTIMES File.

98. Danny M. Leipziger, *Korea Has Yet to Separate Corporate Management from Ownership in Reform*, KOREA HERALD, Nov. 3, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. The World Bank has actively participated in the corporate governance reforms. See Interview with Dr Sri-Ram Aiyer, *Bullish on Korea? Yes, But*, AMCHAM J., (Am. Chamber of Com. in Korea), Jan.-Feb. 2000, at 37.

99. See Kim, *supra* note 66, at 67.

100. *Troubled Mt. Kumgang*, KOREA HERALD, June 24, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

companies, established long term plans and implemented directives from the group chairman. The chairman's office had no legal status and was not an "organ" of the company (e.g., meetings of the shareholders or board of directors) as defined in the Commercial Code. Indeed, the chairman himself usually was not even a member of the board of directors of any of the group companies. The chairman's office certainly had no legal authority to override the boards of directors of the group companies and its influence sprang from the strong personal ties that group executives had to the chairman (based on family or regional or school ties) and Confucian respect for authority.¹⁰¹ The current government of President Kim, Dae Jung has demanded that the office of group chairman be abolished, and the chaebols predictably have resisted.¹⁰² Some chaebols have closed down the chairman's office, only to resurrect it as a "restructuring office."

Improvident expansion and collapse

The 1997 financial crisis was the catalyst for Korea's corporate governance reforms.¹⁰³ We have already noted the success of Korea's economic plans, but the situation in mid-1997, just before the crisis, is worth repeating. Korea had recently joined the OECD, its per-capita income exceeded \$10,000 nationwide and \$20,000 in the major cities, it was the eleventh largest economy in the world, the world's third-largest automobile exporter, and one of the largest steel producers and shipbuilders. U.S. commercial specialists in Seoul were reporting that "the development of this economic superstar is far from over."¹⁰⁴ Yet by the end of the year, the "miracle on the Han" seemed to have vanished, and the financial crisis was in full swing. The won lost

101. See Ehrlich & Lee, *supra* note 48, at text accompanying nn.17 & 18; Ehrlich & Kang, *supra* note 48, at text accompanying nn.42 & 43.

102. See, e.g., *Hyundai Official Says Abolition of Group Chairman's Office Practically Impossible*, KOREA HERALD, Mar. 29, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. But after the government and the foreign business community roundly criticized it, Hyundai reversed its position and promised to abolish its CEO Council and its Corporate Restructuring Committee. *Foreigners Call for Separation of Management from Ownership*, KOREA TIMES, Mar. 27, 2000, available in LEXIS, News/By Country & Region/Asia & Pacific Rim Library, KTIMES File; *Hyundai Group CEO Council to Be Dismissed*, JOONG ANG ILBO, Mar. 31, 2000; Yoo Cheong-mo, *Hyundai Chairman Pledges to Loosen Family Control*, KOREA HERALD, Apr. 1, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Government Reconfirms Stance Against Chaebol Restructuring Offices*, KOREA HERALD, Apr. 22, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

103. Unless otherwise noted, this discussion is taken from Ehrlich & Lee, *supra* note 48.

104. 1998 COMMERCE DEP'T COMMERCIAL GUIDE, KOREA 1 (1998).

more than half its value against the U.S. dollar in December 1997.

In retrospect, 1997 began with an ominous sign in Korea when Hanbo Steel, part of a leading chaebol, collapsed. The company had accumulated over \$6 billion in debt, some twenty times its net worth. The money borrowed was used to finance an overly ambitious expansion, for which neither the company nor its bank lenders performed adequate risk analyses. And the whole Hanbo Group was brought down because of extensive cross-payment guarantees among Group companies. It was an example of much that was wrong.

“The primary cause of this corporate distress was the very aggressive, highly leveraged expansion, both in Korea and internationally, of the large chaebol over the last 15 years or so.”¹⁰⁵ Excessive use of debt financing had permitted concentrated share ownership structures, so that the chairmen of some large conglomerates were able to pursue their own ambitions rather than the interests of shareholders at large. Unfortunately, those ambitions often centered on size regarding assets and market share, rather than on profitability or cash flow.¹⁰⁶ The chaebols pursued a relentless expansion policy and that played a key role in the crisis by boosting the level of debt.¹⁰⁷ A group chairman

105. Ira Lieberman, *Korea's Corporate Reforms*, in *KOREA APPROACHES THE MILLENNIUM 1999* (World Bank & Korea Economic Institute eds. 1999) (last visited Dec. 5, 2000) <http://www.keia.com/mill-fulldocument.pdf>.

106. See, e.g., *Time for Chaebol to Face Reality*, *BUS. WK.*, Dec. 14, 1998, at 72. A one volume history of Korea, published before the crisis in 1997, lauds the Korean “damn the torpedoes” attitude. The book quotes a letter written in the late 1960s by a U.S. foreign aid official who is trying to explain the Korean view to his superior: “You are quoted as saying that the conventional economists always underestimate demand for products needed in a growing economy, that Korea should not worry about overcapacity because demand is always underestimated, that estimates of requirements should be made in the ordinary way and then everything should be doubled, and that economic development is too serious a matter to leave to economists who do not understand it adequately.” CUMINGS, *supra* note 71, at 314. For a collection of short articles discussing the causes of the crisis, see *KOREA ECONOMIC INSTITUTE OF AMERICA* (1999) available at <http://www.keia.com/economy99.pdf>.

107. See *Korea in the World Economy: An OECD Appreciation of its Newest Member*, <http://www.oecd.org/media/release/sgkorea11feb99.htm> (last visited Dec. 5, 2000) (on file with author). *OECD Economic Survey of Korea*, <http://www.oecd.org/eco/sur/esu-kor.htm> (July 1998) (on file with author). The causes of the late 1997 financial collapse are explored in two papers published on the website of the Korea Development Institute School of International Policy and Management: Jong-Il You, *Lessons from the Currency - Financial Crisis in Korea*, <http://www.kdischool.ac.kr/vod/Lessons.html> (on file with author) and Nam, *supra* note 88. See also Ehrlich & Lee, *supra* note 48, at text accompanying nn.3-9; Ehrlich & Mann, *supra* note 61, at text accompanying n.57; Danny Leipziger, *Public and Private Interests in Korea: Views on Moral Hazard and Crisis Recovery*, Presentation by a Senior Manager at the World Bank (May 1998) available at <http://www.brandeis.edu/global/research/leipziger.htm> (visited Dec. 5, 2000); Young, *supra* note 88; Jongryn Moon & Chung-in Moon, *Democracy and the Origins of the 1997 Korean Economic Crisis*, at <http://>

did not have to please shareholders outside the family circle in order to retain his control. Managers were thus able to make decisions at variance with economic realities and invest borrowed funds in large risky projects.¹⁰⁸ Prime examples include Samsung's entry into the car industry in the mid 1990s, "an industry characterized by high capital intensity, over-capacity and international trade restrictions,"¹⁰⁹ and Hanbo's continued borrowing to build steel facilities, which culminated in the insolvency of the whole group¹¹⁰ in January 1997 and the collapse of its main lender, Korea First Bank. A more recent example involves what had been the second largest chaebol, Daewoo. In mid-April 1999, Standard & Poor's downgraded the flagship company of the group, Daewoo Corp., amid concerns about the opaque disclosure of liabilities held by Daewoo's overseas units.¹¹¹ The group's debts had actually increased during the crisis as it continued to expand into new businesses,¹¹² and the group finally collapsed in the summer of 1999.

When, in a break with past practice, the government did not step in to try to rescue Hanbo, the Korean banks became frightened and tightened their lending. Then in March 1997, another

www.nyu.edu/globalbeat/asia/moon031898.htm (Mar. 18, 1998); Yoonwoo Choi, *The Economic Crisis in Korea*, at <http://nimbus.ocis.temple.edu/~ychoi/crisis.html>.

108. See Nam, et al., *supra* note 68, at para. 55. The Minister of Finance and Economy phrased it this way in the summer of 1999: "Chaebol owners exercised unlimited control on management as shown through reckless investment." *Min. Kang's Interview*, *supra* note 90.

109. Leipziger, *supra* note 71; *South Korean Restructuring. Cut to Fit*, *ECONOMIST*, Dec. 12, 1998, at 66 (calling Samsung's new car business "the most glaring symbol of chaebol excess").

110. The bankruptcy of the Hanbo Group was the immediate cause of the late 1997 crisis. It was common practice for group members to subsidize each other by giving cross payment guarantees, among other methods. These induced a lender to extend funds to a weaker firm, merely on the strength of a guarantee from a stronger one. Weaker firms survived and stronger ones were burdened. Resources were allocated inefficiently. The whole group was placed in jeopardy if any of the members faced financial distress. See Nam, *supra* note 88; Ehrlich & Mann, *supra* note 61. New debt guarantees among firms of the top 30 chaebol were prohibited in April 1998 and old ones were to be phased out by March 2000 pursuant to Article 10-2 of the Monopoly Regulation and Fair Trade Act. Financial institutions are prohibited from demanding cross guarantees when extending loans. Letter of Intent from the Government of Korea to the IMF, Nov. 13, 1998, <http://www.imf.org/external/np/loi/111498.htm> (last visited Dec. 19, 2000); REPUBLIC OF KOREA MINISTRY OF FINANCE AND ECONOMY, CHALLENGE AND CHANCE: KOREA'S RESPONSE TO THE NEW ECONOMIC REALITY 25 (June 1998). For a summary of a Fair Trade Commission investigation of intra-group subsidization by the top five chaebol, see Republic of Korea Ministry of Finance and Economy, *The Result of Initial Investigation and Deliberation on Unfair Intra-Group Subsidization*, July 31, 1998, http://www.mofe.go.kr/ENGLISH/Data/E_NEWS/A073102.HTM (last visited Jan. 6, 2001).

111. See *Daewoo in Crisis?*, CNN FINANCIAL NEWS, (Apr. 14, 1999), at http://cnnfn.com/worldbiz/emerging_markets/wires/9904/14/daewoo_wg/.

112. See *South Korean Restructuring. Cut to Fit*, *supra* note 108, at 66.

chaebol, Sammi, went bankrupt. Then Kia failed. The Japanese banks, which had extended short-term loans to Korea's sprawling conglomerates, further tightened credit in mid-year in response to the growing troubles in Southeast Asia. In all, one fourth of the top thirty chaebols filed for bankruptcy in 1997, including Hanbo, Sammi, Jinro, Dainong, Kia, New Core, Haitai and Halla.¹¹³ A string of non-performing loans in the financial sector soon followed the string of large-scale corporate failures and this undermined international confidence.¹¹⁴ In the final months of the year, investor confidence plummeted catastrophically. By mid-November, foreign banks had slashed credit lines, and a full-blown liquidity crisis ensued. "The fundamental causes of Korea's currency crisis can be viewed as structural problems within the economy, such as weakened corporate international competitiveness But a more direct cause of the Korean currency crisis was the sudden withdrawal of short term capital, which previously flooded the country."¹¹⁵

A long history of state intervention in the Korean economy had encouraged investment in fields supported by the government. The companies had come to expect the government to bail them out if their plans failed, so their investments were not constrained by caution. Nor did local bankers exercise prudence in extending loans to the chaebols, since bank lending was government directed. The result was that in 1996, Korean companies had external short-term debts amounting to almost \$100 billion, or about a third of Korean GDP.¹¹⁶ As noted, the chaebols had borrowed hugely, supported by "policy loans," or loans the government had directed the banks to extend. Much of their debt was short term, denominated in foreign currency and supported by cross-payment guarantees among group members. They were thus vulnerable to a downturn in the economy.

The potential for disaster was recognized in 1995. An article in *The Economist* in June that year noted that the chaebols had grown big "by piling up huge debts, which makes them vulnerable: a slump in sales could rapidly render them incapable of keeping their repayment schedules."¹¹⁷ The article also said that the collapse of a big chaebol would threaten the "stability of the

113. See Kim, *supra* note 66, at 65 & n.14.

114. See Nam et al., *supra* note 68, at para. 9.

115. Kyeong-won Kim, *IMF Currency Crisis Spurs Increased Economic Competitiveness*, KOREA HERALD, Aug. 16, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

116. See Kunio Saito, *Korea's Economic Adjustments Under the IMF-Supported Program*, (transcript available at <http://www.imf.org/external/np/speeches/1998/012198a.htm>).

117. *A Survey of South Korea*, ECONOMIST, June 3, 1995, at 12.

South Korean financial system, so the government is more or less obliged to guarantee the chaebol's stability. This implicit guarantee, in turn, encourages chaebol to carry on investing wildly."¹¹⁸

There was a cyclical slump in the Korean economy in 1996, caused in part by sharp declines in the prices of such key exports as petrochemicals and semiconductor chips — the latter accounted for 13% of Korea's total exports. Korea was one of the world's leading manufacturers of sixteen megabit DRAM chips, responsible for about a third of global production; Samsung alone accounted for about 18% of world supply. In 1994 and 1995, the chaebols had made huge investments in industries already glutting the world market such as semiconductors and automobiles, contributing to the subsequent weakness in export prices.¹¹⁹

All of these factors are directly related to an absence of corporate governance mechanisms, which in turn allowed for poorly conducted project evaluation and expansion into glutted fields.

These weaknesses stem from the fact that banks and corporations were linked closely with the government in a web of implicit guarantees which had come to be called "Korea, Inc." This close relationship created a moral hazard problem — a too big to fail mentality resulting in excessive risk taking, over investment and insufficient attention to credit and exchange rate risks.¹²⁰

The Korean government moved aggressively to restore confidence. The Won has since stabilized, the stock market has recovered and GDP is growing.¹²¹

Reforms and restructuring, generally

In December 1997 Korea reached agreement with the International Monetary Fund on a \$57 billion stabilization package that included conditions on financial, corporate, labor, investment and other trade-related structural reforms. The first agreement was reached on December 3, which was superseded by a December 24 Letter of Intent to which newly elected President Kim Dae Jung had agreed. The second agreement strengthened and stepped up the pace of reforms. On December 3, the World Bank pledged up to \$10 billion as part of the IMF program. Later that month, the Bank announced an additional \$3 billion

118. *Id.*

119. See 1998 COMMERCE DEP'T COMMERCIAL GUIDE, KOREA, *supra* note 103, at 9; See also, *Chip-makers Gamble on Expensive Production*, INT'L HERALD TRIB., Sept. 26, 1995, at 16.

120. *OECD Economic Survey of Korea*, *supra* note 106.

121. See 1998 COMMERCE DEP'T COMMERCIAL GUIDE, KOREA, *supra* note 103, at 9; See also, *Chip-makers Gamble on Expensive Production*, *supra* note 117, at 16.

economic reconstruction loan and in March 1998 it approved a \$2 billion structural adjustment loan. According to a World Bank announcement on March 26, 1998:

The corporate sector reform calls for the adoption of accounting, auditing and reporting standards which are consistent with international best practice and which shift the responsibility for standard setting and oversight from government to independent professional bodies. Other corporate sector reforms include strengthening the role and accountability of corporate boards [and] liberalizing foreign investment.¹²²

The OECD, which Korea had joined in 1996, also called for corporate governance reform as essential to improve the performance of the economy. Its *Economic Survey of Korea, July 1998*, said that the company law should better state “the legal responsibilities of directors towards the company, conflict of interest rules and transparency norms regarding major transactions with shareholders. Finally, all company boards should include outside directors . . .”¹²³

President Kim Dae Jung, who took office in early 1998, was determined to reform the excesses of the chaebols — their sprawling size, their indebtedness, their one man autocracy. Spurred by the IMF and the World Bank, the reforms reached many corners of the economy. Cleaning up the banks was the top priority but corporate governance received a good deal of attention, as well as:

- restructuring the chaebols by asset sales and government arranged swapping of units amongst themselves (particularly among the top five chaebols, exemplified by the “big bang” deal announced in December 1998), or debt workouts and the arranged “exit” of non-viable firms (especially among the remaining groups, known as the “6-64”),
- fully opening the capital markets to foreign portfolio investment in May 1998,
- simplifying foreign direct investment via the enactment of the Foreign Investment Promotion Act in November 1998,
- allowing hostile foreign takeovers of Korean target firms in May 1998 (more particularly, allowing the purchase of existing shares without the consent of the target board),
- allowing unrestricted foreign ownership of real estate in May 1998, and

122. *World Bank Enhances Support for Korea*, Mar. 26, 1998, <http://www.worldbank.org/html/extdr/extme/1701.htm> (last visited Jan. 6, 2001).

123. *OECD Economic Survey of Korea*, July 1998, <http://www.worldbank.org/html/extdr/extme/1701.htm> (supplanted by the Aug. 1999 Survey) (on file with author).

- allowing firms to fire employees in the event of financial distress or the need to downsize by February 1998 amendment to the Labor Standards Act.¹²⁴

There is an obvious rationale for many of these measures. Korea was in the midst of a liquidity crisis; its sprawling firms were broke. The top chaebols were urged to focus on core competence and to sell off marginal units, to raise cash with which to lower their debt burden. M & A by foreign acquirers was liberalized for the same reason,¹²⁵ as were the purchase of land and portfolio investment.

The common thread of these measures is that none is market led and all depend on the government's resolve to force change.¹²⁶ When the government became dissatisfied with the slow pace of restructuring undertaken by the top five chaebols, it arranged a December 1998 agreement. The top five promised to focus on core competencies, to reduce the number of affiliates through sales and to use funds raised by these "self-rescue" sales to repay debts. In the aftermath of the Daewoo collapse in the summer of 1999, the government announced on August 25 another series of measures to overcome chaebol "resistance" to reform. These included an expansion of the number of required outside directors, a re-introduction of limits on investment in affiliates and requiring public disclosure of intra-group transactions.

All have been resisted to varying degrees by the chaebols, especially the largest ones. The Federation of Korean Industries predictably called for a "hands-off" policy,¹²⁷ although Hyundai Electronics advertised in the international press touting its "profit-oriented management" and "enhancement of managerial

124. For a summary of many of the reforms, see MINISTRY OF FOREIGN AFFAIRS & TRADE, THE ROAD TO RECOVERY IN 1999 - KOREA'S ONGOING ECONOMIC REFORM, at <http://www.mofat.go.kr/web/Reform.nsf/e63f0d3f6b23f37349256770001e5fc2?OpenView> (last visited Dec. 19, 2000); MINISTRY OF FINANCE & ECONOMICS, PROGRESS IN KOREA'S CORPORATE REFORM: Q & AS (Sept. 1999); Lieberman, *supra* note 104.

125. Ehrlich & Mann, *supra* note 61.

126. For example, see the burst of reform announcements on Aug. 25, 1999, following the massive insolvency of Daewoo. See, e.g., *Min. Kang's Interview supra* note 90; *Korea to Raise Chaebol Ownership/Governance Checks*, REUTERS ENG. NEWS SERV., Aug. 25, 1998; *S. Korea Kim Says to End Bad Chaebol Practices*, REUTERS ENG. NEWS SERV., Aug. 25, 1999; *New Chaebol Reform Policy to Tackle Fleet-Like Operations*, KOREA HERALD, Aug. 23, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Additional Measures for Chaebol Reforms*, *supra* note 75.

127. See, e.g., *Chaebol Call for End to State Meddling in Corporate Governance*, KOREA HERALD, Apr. 21, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

transparency.”¹²⁸ The ad may have sought to mollify foreign investors who were dissatisfied with the infighting among the chairman’s family.¹²⁹ Unless the ad is a cynical ploy, it suggests that the chaebols may have to reform themselves if they wish to attract foreign capital.

The core of the reforms is embodied in the Five Point Plan announced by President Kim Dae Jung shortly after he assumed office in early 1998. The Five Points were:

- enhancement of management transparency,
- elimination of cross guarantees,
- improvement of capital structure,
- selection of core competence, and
- strengthening the accountability of controlling shareholders and management.¹³⁰

Transparency issues have been addressed in various accounting reforms. For example, the top thirty groups must now file “combined” financial statements and large listed firms must have an audit committee. These points are discussed *infra*, under the heading “Accounting and Auditing.”

The elimination of cross guarantees and the improvement of capital structure are parts of a multi-faceted “regulatory” approach to reform administered principally by the Korean Fair Trade Commission.¹³¹ The top thirty chaebols were forbidden in 1998 from issuing new debt guarantees on behalf of affiliates (a way of subsidizing a failing firm and burdening a viable one) and existing guarantees were to be “resolved” by March 2000.¹³² The top five apparently did so on schedule.¹³³ The apparent reduction of debt equity ratios is noted *supra* p. 20. The FTC has also scrutinized intra-group transactions to uncover subsidization of weak affiliates by means of transfer pricing, an aspect of its power to police intra-group transactions among the top thirty

128. The ad is a half page, on the front page of *Survey of Kyushu-Okinawa*, FIN. TIMES (London), June 23, 2000, at 1.

129. *Id.* at 15, 38.

130. Ministry of Finance and Economy, *Progress in Korea’s Corporate Reform: Q & A*, KOREA ECON. WKLY., Oct. 11, 1999.

131. See, e.g., *Introduce the Korean Fair Trade Commission (3)* <http://www.ftc.go.kr/english/html/intro3.htm> (last visited Jan. 6, 2001).

132. KOREA FAIR TRADE COMMISSION, ANNUAL REPORT ON COMPETITION LAW AND POLICY IN KOREA, at <http://www.ftc.go.kr/english/html/index.htm> (Oct. 1999). See also, Monopoly and Reg. & Fair Trade Act arts. 10-2, 10-3 (1999) (S. Korea).

133. *Top Chaebol Eliminates Excessive Debt Guarantees*, KOREA HERALD, Apr. 4, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Five Chaebol Clear Cross Affiliate Debt Guarantees*, KOREA TIMES, Apr. 3, 2000, available in LEXIS, News/By Country & Region/Asia & Pacific Rim Library, KTIMES File.

chaebols.¹³⁴ The practice dilutes the core competency of a group and can bring about the insolvency of the whole group. The FTC will also revive a restriction on investments in affiliates in April 2001,¹³⁵ and will permit the chaebols to form holding companies – previously prohibited – for greater transparency in chaebol structure.

The selection of core competence involved the shedding of units, also discussed *supra* pp. 17-18. The government, the banks and the top five chaebols agreed in December 1998 on an ambitious program that was intended to speed up the restructuring of the top five. The aim was to reduce over-capacity and focus on core competence. Among other things, the agreement designated the “core sectors” in which each of the five chaebols (Hyundai, Samsung, Daewoo, LG and SK) would do business. Affiliates that were not part of the designated core competencies were to be sold.¹³⁶

The fifth point, strengthening accountability of controlling shareholders and management, brings us to the heart of our discussion. There have been several waves of reform, beginning with amendments to the principal statutes and regulations in 1998. The Ministry of Finance and Economy organized a Corporate Governance Reform Committee in March 1999, which published a Code of Best Practice for Corporate Governance in

134. The power derives from article 23 of the Monopoly Regulation and Fair Trade Act, which prohibits trading on extremely favorable terms with a related party, and article 49, which empowers the FTC to conduct an investigation. See, e.g., *Additional Measure of Chaebols Reforms*, KOREA ECON. WKLY., Sept. 6, 1999, available in LEXIS, News/By Individual Publication/K Library, KECOWK File (The FTC conducted three inquiries into unfair intra group transactions in 1998 and 1999); Ministry of Finance & Economy, *The Result of Initial Investigation & Deliberation on Unfair Intra-Group Subsidization*, July 31, 1998, <http://kiep.kiep.go.kr/IMF/hot-2-n6.html> (last visited Dec. 19, 2000) (The 2000 National Trade Estimate for Korea, prepared by the United States Trade Representative, notes that fines of approximately \$60 million were levied against the top five chaebol in July 1998 for illegal subsidization).

135. See *FTC Mulls Reviving Restriction on Chaebol Units' Cross Investment*, KOREA HERALD, July 13, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Cap on Cross Affiliate Investment to be Reintroduced in 2001*, KOREA TIMES, Aug. 25, 1999, available in LEXIS, News/By Country & Region/Asia & Pacific Rim Library, KTIMES File. The limit dropped in Feb. 1998 to facilitate corporate restructuring, but there was an unintended consequence. Groups became able to reduce the debt ratios of their affiliates without actually repaying their debts. The Monopoly Regulation and Fair Trade Act was amended in Dec. 1999 to reintroduce the cap (article 10), but enforcement is delayed. See Ministry of Finance and Economy, *Second Half Economic Policy Directives of the Kim Dae-Jung Administration*, http://www.mofe.go.kr/cgi-pub/content.cgi?code=e_ep&no=74 (last visited Dec. 19, 2000).

136. See *Agreement for the Restructuring of the Top 5 Chaebols*, KOREA ECON. WKLY., Dec. 14, 1998, available in LEXIS, News/By Individual Publication/K Library, KECOWK File.

September 1999. The Code does not have the force of law although certain of its suggestions reflect the 1998 amendments and other suggestions that were enacted in a second wave of amendments in late 1999/early 2000. As the Code is not law, we will not review it in detail, except as it is relevant to matters that have been enacted by the National Assembly or promulgated by the Ministries.¹³⁷

We should note that the reform process has not stopped. Recently, the Ministry of Justice recommended further changes to the law, including the enlargement of directors' rights to information about their company, limiting the liabilities of outside directors, making cumulative voting mandatory, and introducing class actions.¹³⁸ The following material is based on the state of the law as of July 2000.

The board of directors and controlling shareholders

Korea's company law is set forth in Book III of the Commercial Code.¹³⁹ It is supplemented by parts of the Securities and Exchange Act, which governs public companies,¹⁴⁰ and the Act Relating to External Audit of Corporation, which governs firms with assets of at least seven billion Won.¹⁴¹ Book III of the

137. For a summary of the Code, written by the Chairman of the Advisory Group to the Committee, see *Corporate Governance Panel Stresses Legal Safeguards for Shareholders*, KOREA HERALD, Oct. 13, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. The main body of the code is in five parts.

Shareholders: The general meeting of shareholders should be conveniently scheduled and located; electronic voting should be considered; the shareholder's proposal system should be made more flexible. Shareholders should be able to obtain relevant corporate information. There is a condemnation of insider trading and self-dealing. The responsibility of controlling shareholders is discussed.

Board of directors: This is the largest part of the Code. The use of committees is encouraged; the proportion of outside directors on the boards of large public companies should be expanded; there should be a nomination committee and cumulative voting; the board should meet at least quarterly; the directors should owe a duty of care and loyalty, tempered by a business judgment rule and indemnity insurance; the performance of management and board members should be evaluated.

Audit systems: Large public corporations should have an audit committee. External auditors should be independent.

Stakeholders: The roles of creditors and labor are discussed.

Management monitoring by the market: Takeovers and the disclosure of material information are discussed.

138. See *Korean Corporate Governance for Reinforcement of International Competitiveness: Final Report and Recommendation of Revision of Laws*, COUDERT BROTHERS, SEJONG LAW FIRM, PROF. BERNARD S. BLACK AND THE INT'L DEV. LAW INST., at http://www.moj.go.kr/board/view_boarddata.cgi?board_list=14&serial=5423&reply=1.

139. See COM. CODE art. 1000 (Jan. 1962) (S. Korea), as amended.

140. See Securities & Exchange Act art. 972 (Jan. 1962), as amended.

141. See EXTERNAL AUDIT LAW art. 3297 (Dec. 1980) (S. Korea), as amended.

Commercial Code includes provisions governing the "chusik hoesa," the most popular form of corporate entity.¹⁴² In many ways it resembles the U.S. business corporation. It is a legal entity created by promoters. It issues stock shares with a par value. Its shareholders enjoy limited liability and they vote on the appointment of directors and other matters defined in the Commercial Code or articles of incorporation.

The Commercial Code requires that every chusik hoesa have a board of directors with at least three members. Firms with paid in capital of less than 500 million Won (approximately \$450,000 in U.S. dollars, at rates in mid 2000) may have one or two directors, and if there is only one director the general meeting of shareholders may elect to govern directly. The board acts by resolution to appoint, supervise and remove the managers and generally to execute the business of the company.¹⁴³ The chusik hoesa differs from the U.S. business corporation in two principal respects. It has a "representative director" and a "statutory auditor."

The representative director is a member of the board, selected by the board. He personally represents the company and is authorized by statute to perform "all judicial and extra-judicial acts relating to the company."¹⁴⁴

All corporations are required by the Commercial Code to have a statutory auditor, elected by the shareholders for a term of three years. A statutory auditor is not an independent auditor and need not be a certified public accountant, although the office holder cannot be a director, officer or otherwise employed by the company. The principal responsibility is to be a watchdog for the shareholders by monitoring the execution of the firm's business by the directors. In practice, the post has tended to be a sinecure for retired executives and the statutory auditor has not been independent of the chairman or energetic in the discharge of his duties.¹⁴⁵ So it is remarkable that several cases of forced resignation of internal statutory auditors have recently been reported.¹⁴⁶

142. See COM. CODE art. 288 (S. Korea).

143. See *id.* art. 393.

144. *Id.* art. 389.

145. The statutory auditor may attend meetings of the board of directors and may examine the business and financial conditions of the company. The statutory auditor is required to report on and examine financial statements and business reports prepared by the directors and issued to the general meeting of the shareholders. See *id.* arts. 391-2, 412-2, 412-3, 412-4, 413.

146. See *A Financial Watchdog Set to Improve Independence of Company Auditors*, KOREA HERALD, May 2, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File. When KSE listed or KOSDAQ registered companies remove standing auditors or their standing auditors step down before their terms expire, they should report to the Financial Supervisory Commission. Se-

Perhaps this indicates a reawakening of the statutory auditor to his mission.

The Commercial Code has long given shareholders certain rights to monitor and challenge the acts of the directors. These include the basic rights to appoint directors, pass resolutions concerning fundamental corporate matters and appoint statutory auditors to supervise the activities of the directors. The Commercial Code also allowed shareholders to remove directors with or without cause by means of a two-thirds resolution,¹⁴⁷ to bring derivative suits for damages incurred because of the director's violation of law or the articles of incorporation or neglect of duty,¹⁴⁸ and to seek injunctive relief barring directors from doing certain illegal acts.¹⁴⁹ Five percent shareholders could inspect corporate books and records.¹⁵⁰ In the chaebol context, though, these rights were evidently insufficient to motivate the management to exercise rational business judgment.

Fiduciary duty

Korea has a civil law jurisprudence, yet the Commercial Code lacked the fundamental term of a corporate governance equation. There was no article which stated that the directors owe the corporation or its shareholders a fiduciary duty. They did, however, owe the corporation a duty of care. That duty is incorporated from the provisions of the Civil Code concerning the relationship known as a "mandate," the civil law equivalent of agency. A director was and is required to manage the affairs entrusted to him with the care of a good manager.¹⁵¹

A majority of Korean legal scholars have proposed that a U.S. style business judgment rule be accepted, and the Code of Best Practices suggested that "managerial decisions by the director that are based on due process and also faithful and rational decision-making, shall be respected."¹⁵² The Commercial Code does not include such a defense, however, and we are not aware of any court case which has exonerated a defendant on this ground.

Fragments of a duty of loyalty were also expressed in the Commercial Code. Directors were and are prohibited from com-

curities & Exchange Act art. 84-19(4) (S. Korea). The removal of a standing auditor during his term is subject to the approval of the general shareholders' meeting.

147. See COM. CODE art. 385 (S. Korea).

148. See *id.* arts. 399, 403.

149. See *id.* art. 402.

150. See *id.* art. 466.

151. See *id.* art. 382(2); CIV. CODE art. 681.

152. CODE OF BEST PRACTICES FOR CORP. GOVERNANCE, ch. II, art. 8 (S. Korea).

peting with the company or entering into transactions with it.¹⁵³ Scholars long believed that a duty of loyalty might be inferred from these provisions but the point had not been settled.

A trial court in Seoul relied upon a duty of care and a duty of loyalty in a landmark case decided in July 1998.¹⁵⁴ A group of shareholders brought a derivative action, the first in Korea, against four former executives of Korea First Bank, alleging that loans were improperly extended to Hanbo Steel and General Construction Co. Hanbo's January 1997 insolvency precipitated the collapse of the Bank. The Seoul District Court found that two of the executives, both presidents of the bank, had taken bribes. The other two directors knew that Hanbo was a bad credit risk, that the loans had not been properly screened, were unsecured and grossly ill advised, but did nothing to object. Liability was based on Commercial Code article 399, which concerns the liability of a director to the company. The District Court sug-

153. See COM. CODE arts. 397, 398 (S. Korea).

154. See *Kim Seon-Hwa v. Lee Chul-Su*, Seoul Civil District Court, Jul. 24, 1998, 97 Gahap 39907. See 23 ADVOCACY FOR A DEM. SOC. 154, 154-167 (Sep. 1998). For accounts of the case, see *Court Orders Ex-KFB Managers to Pay \$31 Million to the Bank*, KOREA HERALD, July 24, 1998, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Responsible Management*, KOREA HERALD, July 26, 1998 (editorial), available in LEXIS, News/By Individual Publication/K Library, KHERLD File; Joseph Sargent, *Taking on the Chaebol*, GLOBAL FIN., Oct. 1998, at 12 (on file with author).

The Participatory Economy Committee of a group called People's Solidarity for Participatory Democracy organized the plaintiff shareholders. The PSPD's web site is available at <http://www.pspd.or.kr/eng/ehome.html>. In addition to the First Bank litigation, the PSPD has organized three lawsuits involving various Samsung companies, one involving the Daedong Bank, one involving Korea Telecom and one involving Daewoo. One of the Samsung cases is worth noting. The PSPD sought judicial invalidation of bonds with warrants issued by Samsung SDS. The bonds had been issued to relatives of Lee, Gun-Hee, the Samsung group chairman. On May 9, 2000, the Seoul High Court barred the defendants from converting the debt instruments into shares. The board of directors lacked the authority to approve the issue, as article 516-2(4) of the Commercial Code requires the particulars of the instruments to be stated in the articles of incorporation or to be approved by a special resolution of a general meeting of shareholders. The case is noteworthy because many chaebol founders and their sons have caused the group companies to issue low priced bonds with warrants to transfer dynastic wealth while avoiding inheritance taxes. The Financial Supervisory Service has recently strengthened disclosure rules for the pricing of bonds with warrants. See *Measures Introduced to Promote Sound Issuance of BW*, FIN. SUPERVISORY COMMISSION, June 14, 2000, at <http://www.fsc.go.kr/cframe.asp>.

The Samsung litigation took an odd twist on June 23, 2000 when the Seoul High Court reversed itself and dissolved the injunction. While commenting that the transaction appeared to be dishonest, the court believed that an annulment of the BWs would have brought instability to the stock market. See *Minority Shareholders Powerless to Block Father to Son Succession at Samsung Group*, KOREA HERALD, June 26, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

gested that it was prepared to recognize a business judgment rule defense, but not on the facts of this case:

Directors of a company have the discretion to make a business judgement *intra vires*. Adventure and attendant risk necessarily accompany management of a company. So if directors decide and perform their functions honestly within a reasonable extent being required in their handling of corporate affairs, they should not be liable for the loss of company by reason of failing to perform the duty of care even though their acts resulted to the corporate loss.¹⁵⁵

Given the dishonesty and corruption, the court held the defendants liable for damages to the company arising from the irrecoverable loans. Each of the defendants was ordered to pay the bank 10 billion Won for a total of 40 billion Won. Their liability was affirmed by a January 4, 2000 judgment of the Seoul High Court,¹⁵⁶ although the damages were reduced to one billion Won for which the defendants are jointly and severally responsible. The case is now pending before the Korean Supreme Court.¹⁵⁷

The Commercial Code was amended in December 1998, with immediate effect. Among the amendments is a new declaratory provision, article 382-3, which states that directors must perform their duties faithfully according to law and the articles of incorporation. The intent of the National Assembly was to impose a duty equivalent to the fiduciary duty of Anglo-American law.

De facto director

Another amendment deals with the problem of the shadow director. In many cases, the group chairman has not been a registered director¹⁵⁸ of any group company and could not be held accountable for the business performance of the chaebol, even though he enjoyed sweeping autocratic control.¹⁵⁹

New Commercial Code article 401-2 provides that a controlling shareholder who has participated in the business of the company shall be deemed a *de facto* director.¹⁶⁰ The 1998 revision

155. Kim Seon-Hwa v. Lee Chul-Su, Seoul Civil District Court, Jul. 24, 1998, 97 Gahap 39907. See *ADVOCACY FOR A DEM. SOC.* 154, 154-167 (Sep. 1998).

156. See Kim Seon-Hwa v. Lee Chul-Su, Seoul High Court, Jan. 4, 2000, 98 Na 45982, *aff'g* 97 Gahap 39907. See *Appeal of Derivative Suit in First Bank Adjudged*, <http://www.bittbank.com/bittnews/juju.htm> (last visited Dec. 7, 2000).

157. See *First Bank v. Lee Chul-Su*, Supreme Court, filed Feb. 10, 2000, 2000 Da 9086.

158. That is, a member of the board of directors, as shown on the official company register.

159. Members of the boards of directors of group companies have tended to serve the chairman.

160. COM. CODE art. 401-2 (1998 S. Korea).

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- 1) Any person prescribed in the following subparagraphs, in respect to the functions he directed or performed, shall be considered as a director for the purposes of articles 399, 401 and 403—
 1. every person who directed the performance of functions to a director by taking advantage of his influence over the company;
 2. every person who directly performed the functions of a company in the name of a director; or
 3. every person who performed the functions of a company by use of any title such as honorary chairman, chairman, president, vice-president, chief director, managing director or director, from which it may be assumed that he has authority to perform functions of a company even in cases where he is not a director.
 - 2) For the purposes of subsection 1, a director who is liable for damages to the company or third party shall be held liable jointly and severally with every person prescribed in subsection 1.

Article 399 of the Commercial Code concerns the director's liability to the company. Article 401 concerns the director's liability to third parties and article 403 concerns derivative suits by shareholders.

Article 399 (Director's Liability to Company)

- (1) If directors have acted in contravention of any law or regulation or of the articles of incorporation, or have neglected to perform their duties, they shall be jointly and severally liable for damages to the company.
- (2) If any act mentioned in the preceding paragraph has been done in accordance with the resolution of the board of directors, the directors who have assented to such resolution shall be deemed to have done such act.
- (3) The directors who have participated in the resolution mentioned in the preceding paragraph and who have not expressed their dissent in the minutes shall be presumed to have assented to such resolution.

Article 401 (Directors' Liability to Third Persons)

- (1) If directors have neglected to perform their duties with wrongful intent or with gross negligence, they shall be jointly and severally liable for damages to third persons
- (2) The provisions of Article 399 (2) and (3) shall apply mutatis mutandis in the case mentioned in the preceding paragraph.

Article 403 (Action by representative of shareholders)

- (1) Any shareholder who had held at least one percent of the issued shares may demand the corporation to institute an action to enforce the liability of directors
- (2) The demand mentioned in the preceding paragraph shall be made in writing stating the reason thereof.
- (3) If the corporation has failed to institute such action within 30 days from the date on which the demand mentioned in the preceding paragraph was received, the shareholder mentioned in paragraph 1 may immediately institute such action on behalf of the corporation.
- (4) If irreparable damage may be caused to the corporation by the lapse of the period mentioned in the preceding paragraph, the shareholder mentioned in paragraph 1 may immediately institute such action notwithstanding the provisions of the preceding paragraphs.
- (5) The institution of an action shall not be affected even if, after commencement, the shareholding of plaintiff decreases under 1 percent of the issued shares (except when he ceases to be a shareholder).
- (6) In case the action mentioned in paragraphs 3 and 4 has been instituted, the person concerned cannot withdraw the action, surrender

imposes the liability of a director on a group chairman even if he does not serve as a director. Liability is not limited to the group chairman. Under the statute, three types of persons are potentially responsible. First, a person who instructs a director in his conduct of the business of the corporation by exercising his influence over the corporation may be held responsible. An example would be a controlling shareholder who goes beyond the mere exercise of voting rights at a meeting of shareholders. Second, a person who does not serve as a director but conducts the business of the corporation in the name of a director may be held responsible. An example would be a person who keeps and uses the signature seals (“chop” or “tojang”) of the directors whom he controls. Third, a person who is not a member of the board but who conducts the business of the corporation by using a title which appears to confer authority to do so may be held responsible. Examples include honorary chairman and group chairman.

Independence

Members of the board of directors of chaebol group companies have tended to be relatives of the chairman or have other ties to him and his family. They have not been independent. The first attempted solution came in February 1998. An amendment to the Regulation on Securities Listing, required that at least one quarter of the board of a Korea Stock Exchange listed company must be “outside” directors who meet defined qualifications to ensure their independence from the company’s largest or major shareholder and management.¹⁶¹ For example, an outside director could not be the largest shareholder or “specially related to” the largest shareholder, or be the spouse or family member of a major shareholder, an officer, or another director, and cannot be a current officer or have been an officer within the previous two years. Breach of the rule could result in divestiture of the privilege to be traded on the Stock Exchange.

The Rule has been followed. The boards of listed firms do have the required complement of outside directors. A recent newsletter published by the Financial Supervisory Service described the composition of the boards of directors at securities

or admit the claim or reach a settlement without permission of the court.

(7) The provisions of paragraphs 3 and 4 of article 176 and article 186 shall apply *mutatis mutandis*.

161. New article 48-5 was promulgated by the Korea Stock Exchange and approved by the Financial Supervisory Commission. Listed firms were required to appoint only one outside director in 1998. The regulation became fully effective in April 1999, and it remains in effect even though the SEA now includes similar provisions.

houses and the listed firms had the required number of outside directors.¹⁶² In a prominent example of compliance, the March 1999 meeting of shareholders of Pohang Iron and Steel Co. (POSCO) amended the articles of incorporation so that eight of the fifteen directors would be outside directors.¹⁶³

But according to research reports by the KSE, the outside directors tended to be lawyers, accountants and professors who had little experience managing a company. More than half were recommended by the major shareholders and as of March 1999, approximately half had yet to express an opinion against the agenda for a meeting or important management policies.¹⁶⁴ In August 1999, it was widely believed that the chairman selected the required cadre of outside directors from among his friends and relatives.¹⁶⁵ Of 1,244 outside directors serving on the boards of 636 listed companies, fewer than one-third had managerial experience and more than one-third were professors, lawyers and journalists.¹⁶⁶ The Financial Supervisory Service survey of the boards of securities houses similarly shows that more than 25% of the outside directors are academics, 9% are lawyers and 5% are CPAs.¹⁶⁷

That should not have been a surprise. Korean firms had neither nominating committees nor access to an established pool of reliable outside directors.¹⁶⁸ The evidence also suggests that the outside directors have not been given sufficient information to do their jobs. A Korea Stock Exchange study found that outside directors attended fewer than half the board meetings

162. See *Corporate Governance Improvement at Securities Companies*, FIN. SUPERVISORY SERV., June 14, 2000, at <http://www.fsc.go.kr/cframe.asp> or <http://210.95.55.128/eintro.asp>.

163. See *POSCO Adopts New Corporate Governance System*, KOREA HERALD, Mar. 17, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *POSCO to Introduce Global Professional System*, KOREA ECON. WKLY., Mar. 24, 1999, available in LEXIS, News/By Individual Publication/K Library, KECOWK File.

164. See *Outside Director is Puppet?*, DONG A ILBO, Mar. 1, 1999; *Thirty-seven Percent of Outside Directors Don't Know Enough About Management*, DONG A ILBO, Mar. 24, 1999.

165. See *Corporate Reform Committees Sets Sights on Abuses of Outside Directors*, KOREA HERALD, Aug. 6, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

166. See *Among Outside Directors, Managers Professors Most*, DONG A ILBO, Sept. 26, 1999.

167. See *Appointment of Outside Directors and Audit Committee in Securities Companies*, FIN. SUPERVISORY SERV., Press Release # 1398, June 2, 2000.

168. See *Gov't New Chaebol Reform Package Riddled with Loopholes, Critics Assert*, KOREA HERALD, Aug. 27, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

from April 1999 to February 2000.¹⁶⁹ The writer concludes that outside directors had not been given necessary information and could not participate usefully in the meetings.

The Code of Best Practices recommended that the proportion of outside directors be increased from one-fourth to one-half in companies with assets in excess of one trillion Won.¹⁷⁰ But increasing the number of outside directors accomplishes little if the directors are passive. The Code did recommend that firms have a nominating committee¹⁷¹ and that the corporation provide outside directors with the information necessary to perform their duties.¹⁷² The Code's definition of independence was lamentably brief, however: "Outside directors shall hold no interests that may hinder their independence from the corporation, management or controlling shareholder."¹⁷³

Some of the Code's suggestions were adopted in January 2000 amendments to the Securities and Exchange Act. The SEA essentially adopted the Listing Regulation's definition of independence. It is an extensive definition. An "outside director" is a director who is not engaged in the daily affairs of the company¹⁷⁴ and who is not:

- someone who falls under article 191-12(3) 1-4 (a minor, an incompetent, a bankrupt or a felon),
- the largest shareholder,
- "specially related" to the largest shareholder (including a brother, for example),
- a major shareholder (defined in article 188(1) to include 10% shareholders and those who exercise actual influence on important operational matters such as the appointment and dismissal of officers),
- the spouse or lineal ascendant/descendant of a major shareholder,
- an officer or employee of the company or an affiliate,
- a spouse or lineal ascendant/descendant of an officer,
- an officer or employee of a company that has an important relationship with the concerned company,
- an officer or employee of a company for which an officer or employee of the concerned firm has been a non-management director, or
- someone who may have difficulty performing his functions as an outside director or who might be influenced by the

169. See *Outside Directors: A Monitoring Mechanism or Window Dressing?*, KOREA HERALD, Mar. 28, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

170. See CODE OF BEST PRACTICES FOR CORP. GOVERNANCE, ch. II, art. 2.2, (1999 S. Korea).

171. See *id.* art. 3.1.

172. See *id.* art. 4.2.

173. *Id.* art. 4.1.

174. See Securities & Exchange Act art. 2(19) (S. Korea).

management of the concerned company, defined in article 37(2)-3 of the Enforcement Decree as a person who serves simultaneously as an outside director or outside auditor of two or more other companies, or a person who is a CPA or lawyer or other advisor to the concerned company.¹⁷⁵

A KSE-listed company must still have at least one-fourth of its board filled by outside directors.¹⁷⁶ But a large listed company, with assets of at least two trillion Won,¹⁷⁷ must have a board with at least three outside directors. At least half the board must be outside directors.¹⁷⁸ This amendment took effect immediately upon enactment on January 21, 2000. Article 48-5 of Listing Regulation, which first required outside directors, is still in effect. It tracks the SEA provisions. Another January 2000 amendment to the SEA requires large listed companies to have a nominating committee to recommend outside director candidates. The committee must consist of at least two directors and at least half of the directors on the committee must be outside directors.¹⁷⁹ A December 31, 1999 amendment to the Commercial Code article enables the board of a *chusik hoesa* to create committees.¹⁸⁰ POSCO's articles of incorporation provide a current example:

Article 30 [Recommendation of Candidate for Outside Directors]

- (1) A candidate for outside director shall be recommended by the Director Candidate Recommendation

175. *See id.* arts. 54-5(4), 191-16(3).

176. *See id.* art. 191-16(1).

177. *See id.* art. 84-23(1) (wherein the Code's threshold was doubled.)

178. *See id.* art. 191-16(1).

179. *See id.* arts. 191-16(3), 54-5(2).

180. Specifically, the code provides:

- (1) The board of directors may create one or more committees in accordance with the provisions of the articles of incorporation.
- (2) The board of directors may delegate its powers to committees, except on the following particulars:
 1. the proposition of matters which shall be approved by the general meeting of shareholders
 2. the appointment and removal of the representative director
 3. the creation of a committee and the appointment and removal of its members
 4. the matters provided in the articles of incorporation
- (3) A committee shall consist of two or more directors of the corporation.
- (4) A committee shall notify each director of the resolved matter. In this case, each director who has received the notification may convene the meeting of the board of directors, and the board of directors may re-resolve the matter resolved by committee.
- (5) Sections 386(1), 390, 391, 391-3 and 392 shall be applicable *mutatis mutandis* to committees. [These sections concern the procedures for convening and conducting meetings.]

Committee as prescribed in Paragraph (1) of Article 45. . . .

(2) A candidate for outside director may be recommended to the Director Candidate Recommendation Committee by a shareholder holding the voting shares of the company.

(3)

Article 45 [Special Committee]

(1) The company shall have a Director Candidate Recommendation Committee. . . .

(2) The Director Candidate Recommendation Committee shall consist of one (1) standing director and three (3) outside directors. . . . [T]he chairman of each committee shall be appointed by the members of the committee from among the outside directors.

(3)¹⁸¹

DISCLOSURE REGULATIONS

FTC Regulation

The FTC now regulates board conduct. FTC Notification No. 2000-2 took effect on April 1, 2000. It was promulgated pursuant to a new article 11-2 of the Monopoly Regulation and Fair Trade Act, added by December 1999 amendment. The Notification grew out of President Kim's efforts in late August 1999 to strengthen his chaebol reforms.¹⁸² The Notification applies to corporations belonging to the ten largest chaebols. Certain "large scale intra group transactions" require the prior approval of the board of directors and public disclosure. A large-scale transaction is one that exceeds 10 billion Won or 10% of the capital stock of the concerned party. The regulated transactions include an offer of capital, securities or assets. The prior approval of the board must be voted by the whole board and not by a committee. The board's approval must be publicly disclosed within one day.

The Notification has no U.S. analogue. The purpose is to police unfair intra-group subsidies, which has been a core mission of the FTC.

KSE Disclosure Regulation

The Disclosure Regulations for Listed Companies, promulgated by the Korea Stock Exchange, now require listed companies to disclose certain resolutions of the board of directors, such

181. POSCO Articles of Incorporation art. 30, 45 available at <http://www.posco.co.kr/en/ir/shareholder/jungkwan.html>.

182. See *Additional Measures for Chaebol Reforms*, *supra* note 75.

as an increase or decrease of capital or a purchase or disposal of treasury shares, the appointment and removal of an outside director, and the introduction or abolishment of cumulative voting. This revised Regulation took effect on April 1, 2000.¹⁸³

FSC/FSS Disclosures on Corporate Governance

As of April 2000, KSE listed and KOSDAQ registered firms are required to disclose in their annual, semi-annual and quarterly reports their compliance with the Code of Best Practices for Corporate Governance. This is required by the Financial Supervisory Commission's Regulation Relating to Notification of Important Managerial Facts and Annual Reports by Listed Companies and the Guide for Preparation of Annual Reports published by the Governor of the Financial Supervisory Service. The official forms to be used in preparing the reports include various disclosures about corporate governance, including:

- whether profiles of candidates for directors were disclosed prior to the shareholders' meeting,
- details of the outside director nominating committee,
- details of the outside directors,
- details and performance of any board committee,
- whether an audit committee has been established and details of its composition, and
- whether the rights of minority shareholders have been enhanced.¹⁸⁴

Similar disclosures are also required in the registration statement filed by an issuer of securities. This is required by the Financial Supervisory Commission's Regulation Relating to Registration of Securities and the Guide for Preparation of Registration Statement, published by the Governor of the Financial Supervisory Service.

ACCOUNTING AND AUDITING

In addition to lacking independent directors who are not dominated by the chairman, Korean companies have suffered from "transparency" problems. These include accounting and auditing practices that fail to detect or disclose the condition of the firm and inadequate dissemination of information about the performance of the firm.

The *Journal of the American Chamber of Commerce in Korea* warned in 1998 that "accounting transparency remains a goal rather than a reality" and that "taking the figures in audited fi-

183. See KOREA STOCK EXCHANGE DISCLOSURE REG. arts. 4(1), 4(2) (S. Korea).

184. The new disclosures are described in *Weekly Newsletter*, FIN. SUPERVISORY SERV., Apr. 12, 2000.

nancial statements for granted is not appropriate in the Korean context.”¹⁸⁵ The comments concerned the conduct of a due diligence inquiry in an M & A transaction. In its loan agreements with Korea, the IMF emphasized problems with Korean accounting, and the agreements require that “Korea reform its murky economic practices and become a more transparent economy.”¹⁸⁶ Indeed, the IMF had some difficulty determining the full extent of Korea’s external debt. The short term foreign currency debt, over \$100 billion, exceeded estimates by more than \$50 billion due to undisclosed borrowing by overseas subsidiaries and Korean companies and banks. The December 3, 1997 Memorandum on the Economic program, sent to the IMF, stated:

The government recognizes the need to improve corporate governance and the corporate structure. To that end, transparency of corporate balance sheets (including profit and loss accounts) will be improved by enforcing accounting standards in line with generally accepted accounting practices, including thorough independent external audits, full disclosure and provision of consolidated statements for business conglomerates.¹⁸⁷

There have been several accounting reforms. Some of them are technical; others concern the basic duty of a CPA to be diligent, honest and independent. The technical changes are of two sorts. First, the External Audit Law¹⁸⁸ was amended effective April 1998 to require that the thirty largest chaebols designated by the Fair Trade Commission issue “combined” financial statements for fiscal years that begin on or after January 1, 1999.¹⁸⁹ The Securities and Futures Commission in October 1998 issued standards for the combined financial statements. The intention is to eliminate transactions among affiliates and to require disclo-

185. Hank Morris, *M & A in Korea: Getting it Right*, AMCHAM J., (Am. Chamber of Com. in Korea) Nov.-Dec. 1998, at 26; Ken Cook, *A Foreign Buyer’s Look at M & A in Korea*, AMCHAM J., (Am. Chamber of Com. in Korea) Nov.-Dec. 1998, at 31.

186. Ehrlich & Mann, *supra* note 61.

187. *Id.*

188. Article 2 of the External Audit Law requires that firms of a designated size, currently defined by the Enforcement Decree article 2(1) as those with assets of 7 billion Won or greater, have their annual financial statements audited by certified public accountants. EXTERNAL AUDIT LAW art. 2, § 3297 (Dec. 31, 1980 *as amended* Jan. 12, 2000) (S. Korea). The Securities and Exchange Act, article 194-3(1), also requires that publicly traded firms (KSE and KOSDAQ) are subject to external audit.

189. The combined statements differ from consolidated statements, which have been required of listed firms since 1993. Firms with common ownership use consolidated statements and they eliminate intra group transactions. Companies that are under common control (as with chaebol firms) use combined statements but they do not eliminate intra-group transactions. The Korean statements are a hybrid. They apply to a group of firms under common control and they also eliminate intra-group transactions.

sure of intra-group transactions, so that the affairs of the chaebol are presented as a whole. However, affiliated firms with assets of less than seven billion Won are excluded from the companies to be combined.¹⁹⁰ This may be a loophole, though an arguably trivial one. False transfer pricing profits between a large member firm, which sells to a small member firm, will not be eliminated from the presentation of the group's affairs.

Second, accounting standards were revised in December 1998 by the Financial Supervisory Commission and the Securities and Futures Commission. These revised standards apply to firms covered by the External Audit Law and concern seven points: foreign currency translation, troubled debt restructuring, mandating the equity method for investment associates, accounting for asset impairment, effects of accounting changes and error corrections, disclosure of segmental information and accounting for derivatives. The intention was to bring Korean accounting standards closer to International Accounting Standards (IAS) or U.S. standards.¹⁹¹

A third change is less technical but has a narrow scope. Corporations that are required to file annual reports under the Securities and Exchange Act (that is, publicly traded firms), are now required to file quarterly and semi-annual reports as well. The semi-annual reporting requirement dates back to January 1997; the quarterly reports are required by a February 1999 amendment to the Securities and Exchange Act.¹⁹² The reports are filed with the Financial Supervisory Commission and the KSE or KSDA (Korean Securities Dealers Association). The two quarterly reports include unaudited financial highlights as well as information relating to corporate governance, including the status of outside directors and auditors and the strengthening of minority shareholders' rights. The quarterly reports will be disclosed via the Internet at <http://dart.fss.or.kr>.¹⁹³

A fourth set of reforms concern the appointment of an outside auditor. Although large companies and publicly traded companies are required to prepare financial statements audited

190. See EXTERNAL AUDIT LAW art. 1-4(2) (S. Korea).

191. For an account of one of the problems addressed by the new standards, foreign currency translation, see *Accounting for the Asia Crisis*, WORLD ACCT. REP., July 1998 (London)(describing how POSCO was able to defer reporting huge foreign exchange losses and thereby convert a net loss into a net profit). The new rules are noted in *Rules Change Will Force Firms to Come Clean*, BUSINESS KOREA, Jan. 1999 (Seoul).

192. See Securities & Exchange Act § 186-2(1) (S. Korea) (requiring annual reports); Securities & Exchange Act § 186-3 (S. Korea) (requiring semi-annual and quarterly reports).

193. The introduction of the quarterly reports is described in the *Weekly Newsletter*, FIN. SUPERVISORY SERV., May 24, 2000.

by independent accountants, the law did not define the quality of “independence” or establish a policing mechanism. The first changes came in February 1998. The Rules on Securities Listing, which required the appointment of outside directors as discussed above, also gave the Korea Stock Exchange the power to recommend the appointment of independent outside auditors for firms listed on the KSE.¹⁹⁴ The qualifications for an outside auditor were the same as for an outside director. If a listed company failed to accept such a recommendation, the KSE could disclose that fact to the public.

The External Audit Law, which applies to firms with assets of at least seven billion Won, was amended at the same time to require the creation of an auditor selection committee. The auditor selection committee was to consist of:

- two internal, statutory auditors, at most,
- two outside directors, at most,
- two shareholders with the largest number of voting shares, but not the controlling shareholders or anyone specially related to them, and
- two persons recommended by the presidents of the two banks, which have loaned the firm the most money, but not the controlling shareholders or anyone specially related to them.¹⁹⁵

KSE listed companies and chaebol member firms that file combined financial statements were required to appoint their external auditor upon the recommendation of the auditor selection committee and the approval of the shareholders at an ordinary general meeting of shareholders.¹⁹⁶ A listed firm had to and must still appoint the same external auditor for three consecutive accounting periods.¹⁹⁷ Other firms subject to the External Audit Law could consider the advice of the auditor selection committee but were not bound to follow it. They could appoint their auditor based upon the recommendation of the statutory auditor or the auditor selection committee, and the approval of the shareholders.

A year and a half later, the Code of Best Practices suggested that the board should be able to establish committees, including an audit committee.¹⁹⁸ Large public corporations (assets in ex-

194. See Regulation on Securities Listing art. 48-6 (S. Korea). The auditor is called “outside” or “external” to distinguish it from the statutory auditor.

195. EXTERNAL AUDIT Law art. 3-2(1) (S. Korea); Reg. on External Audit of Corp., § 8 (S. Korea). This regulation was promulgated by the Financial Supervisory Commission on March 12, 1999.

196. See EXTERNAL AUDIT LAW art. 4(2) (S. Korea).

197. See *id.* art. 4-2(1).

198. See CODE OF BEST PRACTICES FOR CORP. GOVERNANCE, ch. II, art. 6.1 (S. Korea).

cess of one trillion Won) should be required to do so.¹⁹⁹ The Code described the composition and duties of an audit committee. An audit committee would supplant an auditor selection committee by recommending an external auditor. The other suggested functions of an audit committee closely resemble the work of a U.S. audit committee.

Next came a December 31, 1999 amendment to the Commercial Code, article 415-2.²⁰⁰ This permits the board of a chusik hoesa to create an audit committee. The amendment also provides that a company with an audit committee need not have an internal statutory auditor.

The January 21, 2000 amendments to the Securities and Exchange Act incorporated these changes with immediate effect. A large listed company, with assets in excess of two trillion Won,²⁰¹

199. *See id.* ch. III, art. 1.1.

200. The amendment Provides:

- (1) The corporation may, as provided in the articles of incorporation, create an audit committee as a committee under the provision of section 393-2 in lieu of the auditor. [This and all subsequent uses refer to the statutory internal auditor.] In case where the corporation has created the audit committee, the audit shall not exist anymore.
- (2) Notwithstanding the provision of section 393-2(3), the audit committee shall consist of three or more directors. However, the following persons shall not exceed 1/3 of the members of the audit committee:
 1. managing directors and employees or those who have been managing directors and employees within two years prior to the date of appointment
 2. in case where the largest shareholder is a natural person, himself, his spouse and his lineal ascendants-descendants
 3. in case where the largest shareholder is a legal person, its directors, auditors and employees
 4. a spouse and lineal ascendants-descendants of a director
 5. directors, auditors and employees of a holding or subsidiary company of the corporation
 6. directors, auditors and employees of a legal person who has material interests in the corporation
 7. directors, auditors and employees of another company of whom directors and employees of the corporation have been directors
- (3) The resolution of the board of directors for removal of members from an audit committee shall be adopted by the resolution of 2/3 or more of the total number of directors.
- (4) The audit committee shall, by its resolution, appoint the particular member who will represent the committee. In this case, it may be provided that two or more members shall jointly represent the committee.
- (5) An audit committee may obtain the assistance of experts at the expense of the corporation.

COM. CODE art. 415-2 (S. Korea). There are further sections which concern the appointment of the auditor and an optional requirement that directors own stock of the company. These shall apply to the audit committee and its members.

201. *See* Securities & Exchange Act art. 84-23(1) (S. Korea).

must create an audit committee.²⁰² These are the same firms that must have at least half their board filled by outside directors. At least two thirds of the members of an audit committee must be outside directors.²⁰³ For congruency, article 4(2) of the External Audit Law was amended on January 12, 2000. An audit committee established pursuant to Commercial Code article 415-2 shall satisfy the requirement to have an auditor selection committee.

The Regulation on Securities Listing was amended as well, effective February 28, 2000. The Regulation now empowers the KSE to delist a firm that has failed to elect the required number of outside directors or, in the case of a large listed company, to create an audit committee.²⁰⁴

Article 48-6 of the Regulation on Securities Listing originally gave the KSE the power to recommend the appointment of an independent outside auditor. That too was revised on February 28, 2000. It now simply incorporates the audit committee rules of the SEA. The original rule included a definition of independence and that was deleted in the revision. However, the deletion is not material. The External Audit Law, article 8(3), requires the auditor to be independent.

Punishment has been light for auditors who violate accounting rules and cause investor loss, so there have been two expansions of auditor liability. As part of the February 1998 amendments to the External Audit Law (the others being the requirements of an ASC and combined financial statements at the largest chaebols), the penal provisions were revised. If any person in a defined class intentionally fails to prepare accounting statements, or prepares and discloses false statements, he shall be punished by imprisonment for not more than three years or a fine not exceeding 30 million Won.²⁰⁵ The penalty had been 10 million Won. The defined class of potentially liable persons includes, among others, a director of the company, an external auditor of the company or any other person charged with the accounting affairs of the corporation.

A body of case law concerning the liability of an accountant has also developed. While the relevant statutes predate the crisis and the case law began to emerge in the early 1990's, a leading judgment of the Korean Supreme Court was decided in April

202. *See id.* art. 191-17.

203. *See id.* arts. 191-17(2), 54-6(2).

204. *See Reg. on Securities Listing* art. 37(4) (S. Korea).

205. *See EXTERNAL AUDIT LAW* art. 20 (S. Korea). This article requires that financial statements under the External Audit Law must be filed with the Securities and Futures Commission, an agency under the authority of the supreme financial supervisory body, the Financial Supervisory Commission. *See* <http://www.fsc.go.kr/cframe.asp>. The SFC is responsible for audit review.

1998, shortly after the External Audit Law was amended. While there is no explicit connection, the timing and context of the judgment enhance its significance.

The first relevant court decision was in 1993. The inventories and debts of the Heungyang firm were misstated in order to disguise the firm's debts and make a net operating loss appear to be a profit. The Seoul Civil District Court held that investors who suffered losses due to false corporate financial statements could recover from the CPAs who manipulated the accounts.²⁰⁶

Various statutes impose a duty of due care. As a general rule of civil law, "any person who has caused damages to . . . another person by unlawful act, intentionally or negligently, shall be liable to compensate the damages arising therefrom."²⁰⁷ The unlawfulness of producing a misstated financial report is established by two other laws, article 17 of the External Audit Law²⁰⁸ and article 197 of the Securities and Exchange Act.²⁰⁹

Following the Heungyang decision, disappointed investors filed a number of similar lawsuits. The better known cases con-

206. See *South Korea: CPAs Have to Pay for Bogus Audits*, KOREA ECON. DAILY, Feb. 26, 1993.

207. CIV. CODE art. 750 (S. Korea).

208. The Act Relating to External Audit of Corporation: Article 17 (Compensation Liabilities of Auditor) provides:

- (1) If the auditor has caused damages to the company by neglecting to perform his duties, such auditor shall be liable to compensate the damages to the company. In case the auditor is an auditor team, the certified public accountants (CPAs) who have participated in the auditing of the concerned company shall be liable to jointly and severally compensate the damages to the company.
- (2) If the auditor has caused damages to a third person (who has relied thereupon) due to making an untrue statement of material fact in the audit report or omitting to state a material fact to be stated therein, such auditor shall be liable to compensate the damages to the third person. . . .
- (3) The second sentence of paragraph (1) shall apply mutatis mutandis to the case of paragraph (2).
- (4) . . .
- (5) If the auditor or the certified public accountant who has participated in the auditing proved that he has not neglected to perform his duties, such auditor or certified public accountant is not liable to compensate the damages regardless of paragraphs (1) to (3).
- (6)

EXTERNAL AUDIT LAW art. 17 (S. Korea).

209. Article 197 of the Securities & Exchange Act provides:

- (1) The provisions of paragraphs (2) to (7) of Article 17 of the Act concerning External Audit of Corporations shall apply mutatis mutandis to the compensation liabilities of auditors to bona fide investors.
- (2) The provisions of Article 15 shall apply mutatis mutandis to the calculation of the amount of compensation referred to in paragraph (1).

Securities & Exchange Act art. 197 (S. Korea).

cerned Shinjung Paper Manufacturing Co., Youngone Communications Co. and Koryo Cement Co.²¹⁰ In the Shinjung case, for example, the firm went bankrupt just three months after listing on the stock market. Three CPAs gave an unqualified opinion with respect to the firm's 1990 and 1991 financial statements, even though they had detected misstatements which disguised actual losses as apparent profits.²¹¹

A 1998 judgment of the Korean Supreme Court held responsible the Chungun accounting firm, which prepared the 1992 financial statements for its client, Han Kook Steel Pipe Co.²¹² The inventories and obligations were falsified. Four individual investors purchased shares in Han Kook at various times from August 26, 1993 to November 3, 1993. On November 5, 1993, the Securities Supervisory Board announced that the financial statements were false. The share price dropped. One of the plaintiffs sold some of his shares on November 15, 1993, twelve days after he had bought them. Another sold some of his shares in December 1993. In January 1994, the firm became insolvent, and the share price further dropped to almost nothing. Some investors sold some shares in April 1994; but in the absence of a market for the shares, one continued to hold until June 1995. The auditors were held partly responsible for the losses of the investors. Adopting a "fraud on the market" theory, the Court found that the plaintiffs were affected by the false financial statements. They believed the market price was the correct price for the shares. The plaintiff who sold ten days after the SSB announcement was entitled to fully recover his losses, but the others were required to bear that portion of their losses which could have been avoided had they sold immediately upon the SSB's announcement.

SHAREHOLDER RIGHTS

The board of directors of a publicly traded chaebol firm represented the interests of the founding family. Minority shareholders are now afforded enhanced legal means to protect their interests, though given the costs of enforcing these rights, they cannot be an adequate substitute for an informed and independent board. Some shareholder rights can be exercised by any shareholder, without regard to the number of shares owned by the aggrieved shareholder. For example, any shareholder may bring an action to void a shareholder's resolution adopted in vio-

210. See *External Auditor Judgment Reversed: Injured Investor Lawsuits Will Follow*, DONG A ILBO, Sept. 19, 1997.

211. See *Three CPAs Arrested Over Accounts of Failed Shinjung Paper*, KOREA ECON. DAILY, July 29, 1992, available in 1992 WL 2366117.

212. See *An Jong-U v. Chungun Accounting Firm*, 59 Panryeogongbo 1446, 1446-1449 (Sup. Ct., Apr. 24, 1998).

lation of law or the articles of incorporation.²¹³ Most minority shareholder rights require a certain minimum threshold ownership, though. The 1998 amendments described below lowered many of the thresholds.

There are two sets of rules. One set is found in Book III of the Commercial Code. These rules apply generally to all Korean corporations ("chusik hoesa"). The other set of rules is found in the Securities and Exchange Act ("SEA"), which applies to firms listed on the KSE or traded on the KOSDAQ over the counter market. The Commercial Code amendments described below were enacted in December 1998 and became immediately effective. Most of the SEA amendments were enacted in February 1998 and became effective in April 1998.²¹⁴ The SEA requires that the shares have been held for at least six months for the rights to apply.

Access to basic corporate documents

All shareholders are entitled to inspect the financial statements of the firm,²¹⁵ but only certain shareholders may demand to inspect and make extracts of the underlying books and documents of account.²¹⁶ The Commercial Code amendments lowered the threshold from 5% to 3%.

The SEA amendments lowered the threshold from 3% to 1%. If the paid in capital of the firm is at least 100 billion Won, the threshold is 0.5%.²¹⁷ There was a further amendment in January 2000. Article 14(5) of the External Audit Law now permits any shareholder or creditor of an EAL firm to inspect and copy financial statements (including consolidated and combined statements) and the statement of audit submitted by the external auditor.

Right to inspect corporate affairs and property

If there is any cause to suspect that any dishonest act has been committed or there has been any violation of law or the articles of incorporation in connection with the administration of the company's affairs, a shareholder may apply to court for the appointment of an inspector to investigate the affairs of the com-

213. See COM. CODE arts. 376, 380 (S. Korea).

214. There was a further amendment in January 2000 that affected only large securities companies, with assets of at least two trillion Won. The threshold for minority shareholder's rights has been lowered to half of the standard for a listed or registered company. See Securities & Exchange Act art. 64 (S. Korea).

215. See COM. CODE art. 448 (S. Korea)

216. See *id.* art. 466.

217. See Securities & Exchange Act art. 191-13(3) (S. Korea).

pany and the state of its property.²¹⁸ The Commercial Code amendments lowered the threshold from 5% to 3%.

The 1998 SEA amendments did not lower the threshold, set in early 1997 at 3%. If the paid in capital of the firm exceeds 100 billion Won, however, the threshold is only 1.5%.²¹⁹

Right to seek ouster of a director

Removal of a director may be accomplished by special resolution of a general meeting of shareholders.²²⁰ If the director has committed a dishonest act or has violated the law or the articles or incorporation and a general meeting has failed to remove him, shareholders may go to court to seek removal.

The Commercial Code amendments lowered the threshold from 5% to 3%. The SEA amendments lowered the threshold from 1% to 0.5% and if paid in capital is at least 100 billion Won, to 0.25%.²²¹

Right to demand cessation of an unlawful act

If a director performs an act which violates any law or the articles of incorporation and which threatens irreparable injury to the company, shareholders may demand on behalf of the company that the director cease the activity.²²² The Commercial Code amendments lowered the threshold from 5% of the total issued shares to 1%. The SEA amendments lowered the threshold from 1% to 0.5%; only 0.25% is required if the firm's paid in capital is at least 100 billion Won.²²³

Right to commence derivative litigation

Shareholders may demand that the corporation institute an action to enforce the liability of a director. If the corporation fails to do so within 30 days, the shareholders themselves may sue.²²⁴ The Commercial Code amendments lowered the threshold from 5% of the total issued shares to 1%. The SEA lowered the threshold to .01% in May 1998, from 1% in 1997 and .05% in February 1998.²²⁵ The government chose to keep some ownership minimum and not to adopt a U.S. style rule whereby even a

218. See COM. CODE art. 467 (S. Korea).

219. See Securities & Exchange Act art. 191-13(4) (S. Korea).

220. See COM. CODE arts. 385, 434 (S. Korea).

221. See Securities & Exchange Act art. 191-13(2) (S. Korea).

222. See COM. CODE art. 402 (S. Korea).

223. See Securities & Exchange Act art. 191-13(2) (S. Korea).

224. See COM. CODE art. 403 (S. Korea).

225. See Securities & Exchange Act art. 191-13(1) (S. Korea).

single small shareholder can commence suit, this for fear of a "potential flood of lawsuits."²²⁶

The point may be open for reconsideration. The Ministry of Justice is considering yet another set of corporate governance reforms and individual-based derivative suits is among them. Litigation is a war of attrition, though, and individual shareholders would be better able to seek redress if Korea were to allow class action lawsuits. Derivative litigation can only be used to sue managers who have harmed the company and the recovery goes to the corporation. It cannot be used to vindicate the personal rights of a shareholder, for example, if one has bought or sold shares because of misleading disclosures. Securities fraud cases in the U.S. are often class actions. More to the point, the shareholder's attorney drives shareholder litigation. The court-awarded fees in derivative litigation are small but the fees in a class action suit would be in proportion to the winnings. A bill allowing class actions in securities fraud cases was submitted to the National Assembly more than a year ago but has stalled due to chaebol opposition. The Code of Best Practices is silent about the need to make the litigation remedies feasible.

Right to request meeting of shareholders

In general, the board of directors convenes a general meeting of shareholders. The Commercial Code allows minority shareholders to demand the board to convene an extraordinary general meeting by written request stating the purpose of the meeting. If the board fails to do so, the shareholders may call the meeting themselves with permission of a court.²²⁷ The Commercial Code amendments lowered the threshold from 5% to 3%. The SEA amendments did not lower the threshold, set in early 1997 at 3%. If the paid in capital of the firm is at least 100 billion Won, though, the threshold is only 1.5%.²²⁸

Right to propose agenda at meeting of shareholders

This is a newly created right in the Commercial Code. Shareholders with at least 3% of the voting equity can propose to a director of the corporation the agenda for a meeting of shareholders.²²⁹

226. *Shareholder Activists Call for Tougher Steps to Monitor Chaebol Owners*, KOREA HERALD, Mar. 31, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File; *Government, Chaebol in Clash Over New Corporate Governance Standards*, KOREA HERALD, May 2, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

227. See COM. CODE art. 366 (S. Korea).

228. See Securities & Exchange Act art. 191-13(4) (S. Korea).

229. See COM. CODE art. 363-2(1) (S. Korea).

In early 1997, the SEA granted this right to those holding at least 1% of the issued shares entitled to vote; this is reduced to 0.5% if the paid in capital of the firm is at least 100 billion Won.²³⁰

Cumulative voting

This is a newly created right in the Commercial Code. The amendment became effective in June 1999. Shareholders with at least 3% of the equity are allowed to request the company to adopt cumulative voting when two or more directors are to be elected.²³¹ There is no similar provision in the SEA. The Commercial Code allows companies to exclude this right in their articles of incorporation. Of 600 listed companies which convened a general meeting of shareholders in early 1999, 444 of them had excluded cumulative voting.²³²

Institutional investors

On September 16, 1998, article 25 of the Securities Investment Trust Business Act was amended to permit institutional investors to exercise voting rights directly. Investment trust companies, such as Korea Investment Trust Co., always had voting rights for stocks they held as portfolio investments but rarely exercised the right. Prior to the amendment, institutional investors could not vote the shares directly and had to exercise their rights through the trust company that performed custodial or depository services. The mechanism was cumbersome and institutional shares were not voted. Large share blocks were effectively unavailable as a counterbalance to the power of the controlling shareholder, the chaebol's founding family. Korean institutional investors have not taken a role in monitoring the management of companies in their portfolios, probably because many local funds are owned by the chaebols.

There is some evidence that the foreign institutions may fill the void. At the end of 1998, the value of shares owned by foreigners reached 18.6% of the total market. Over 60% of the foreign investors were institutional investors.²³³ Both numbers rose by the end of 1999, when the value of foreign owned shares was 21.91%, of which institutions held 99.69%.²³⁴ The trend contin-

230. See Securities & Exchange Act art. 191-14(1) (S. Korea).

231. See COM. CODE art. 382-2 (S. Korea).

232. See *Listed Company Makes Cumulative Voting System Powerless*, MAEIL KYUNGJE INTERNET ELECTRIC SHINMOON, Aug. 4, 1999.

233. Nam, et al. *supra* note 68, paras. 32, 65.

234. *Analysis of Foreigners' Investment Tendency in 1999*, FIN. SUPERVISORY SERV., Jan. 2000.

ued through early June 2000, when foreigners owned 28.5% of the total capitalization of the Korea Stock Exchange.²³⁵

What will continue to attract these investors? At a minimum, a stock market is unlikely to function well or attract outside capital without laws that prohibit insider trading and other forms of self-dealing, and Korean law includes these norms.²³⁶ But foreign investors require more than this, of course. Among other things, they want management that delivers shareholder value and does not manipulate the firm for the benefit of an affiliate. The Tiger Fund, which owned shares in SK Telecom, led a proxy fight in March 1998. That resulted in an agreement requiring the appointment of two outside directors and their consent to transactions with affiliates for more than 10 billion Won. This followed a loan by the profitable firm to a troubled affiliate, SK Securities, at a very favorable interest rate.²³⁷ In late 1999, following renewed disagreements with management, Tiger sold most of its stake in the telecom operator to the SK Group at a substantial profit.

More recently, foreign institutional investors sold off their shares of Hyundai Electronics Industries in late April 2000 following the internecine feud among the founding family for management control.²³⁸ Hyundai Heavy Industry has tried to attract foreign investors by improving its corporate governance and stopping undue support to affiliates. It is reported that the foreigners' shareholding in HHI has been reduced from 15% to about 1% as of May 2000, because of foreigners' disapproval of chaebol-style management.²³⁹

So, the situation in Korea is different than in the U.S. The foreign institutions have not sought dialogue (and one can hardly imagine an autocratic chairman having a heart to heart conversation with an outside shareholder who also happens to be a foreigner) or access to the proxy machinery, rated governance

235. *Foreign Investors Increase Share Holdings Despite Fall in Stock Prices*, KOREA HERALD, June 7, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

236. COM. CODE art. 398 (S. Korea) prohibits a director from entering into transactions with his company without the approval of the board; Securities & Exchange Act art. 188 (S. Korea) prohibits insider trading.

237. See Laxmi Nakarmi, *Revolt of the Investor*, ASIaweek, Apr. 3, 1998; Indira Lakshmanan, *Crusader Aims at S. Korea's Corporate Might*, BOSTON GLOBE, Nov. 30, 1998; John Burton, *Chaebol Resist Attempts to Instill Greater Transparency*, FIN. TIMES (London), Mar. 18, 1999, at 6, available in LEXIS, News/By Individual Publication/F Library, FINTME File; Michael Baker, *Little Guy vs. Korean Big Business*, CHRISTIAN SCI. MONITOR, Mar. 26, 1999; Kim, *supra* note 74 at 325.

238. See *No Easy Answer to Hyundai Conundrum*, KOREA TIMES, Apr. 28, 2000, available in LEXIS, News/By Country & Region/Asia & Pacific Rim Library, KTIMES File.

239. See *HHI: Foreign Investors, Come Back*, DONG A ILBO, May 12, 2000.

practices, published lists of the best and worst managed firms, or withheld votes for the re-election of directors, or filed lawsuits against inept or self-dealing managers and directors. They have simply sold.

CONTROL MARKET

Accepted wisdom is that an open market for corporate control is a necessary counterbalance to an entrenched management. "If management either has acted selfishly or has simply failed to make a change in operations or to seize a business opportunity, an outsider can profit by obtaining control, making the appropriate changes and reaping the benefits when the stock price rises to reflect the change."²⁴⁰ Korean law had insulated the controlling owners of the chaebols from the possibility of an uninvited sale of ownership – not that there have been many hostile takeovers. Since 1997, though, the law has been changed in several ways to allow hostile tender offers to be made. There had been extensive restrictions on ownership of publicly traded firms by both foreign and domestic investors and burdensome conditions imposed on the conduct of a tender offer. The limits on share ownership have nearly all been abolished as have the most difficult tender offer rules.

Article 200 of the SEA barred an individual from owning more than 10% of the shares of a listed company. There were some exceptions to the rule, such as founder's shares, but the rule effectively hampered tender offers. The purpose of the rule was to encourage firms to seek listing on the KSE. The limitation was lifted, effective April 1, 1997.

Foreign ownership of the shares of listed firms was additionally restricted. The KSE was opened to foreign investors in 1992. Initially, no single foreigner could own more than three percent of the shares of a listed company and total foreign ownership in any one listed company could not exceed 10 percent. Different limits applied to KOSDAQ firms. The ceilings were gradually raised by the Ministry of Finance, and then, in May 1998, were eliminated in nearly all cases. (There are still limits that apply to POSCO and KEPCO pursuant to special legislation.)²⁴¹

240. Barry E. Adler & Larry E. Ribstein, *Debt, Leveraged Buyouts, and Corporate Governance*, GEORGE MASON UNIVERSITY, available at <http://www.cato.org/pubs/pas/PA120.HTM>.

241. See, e.g., the website of the Korea Stock Exchange, at <http://www.kse.or.kr/> eng; *The Korean Government Still Maintains Foreign Equity Restrictions with Respect to Investment in POSCO, KEPCO, Korea Telecom, Many Types of Media, Schools and Beef Wholesaling*, 2000 NATIONAL TRADE ESTIMATE (U.S. Trade Representative) http://www.ustr.gov/pdf/2000_korea.pdf; See *Financial System*, KOREA CHAMBER OF COM. & INDUSTRY, <http://www.kcci.or.kr/kccinew/08/dbk1/fs.htm#1>

Tender offers were further restricted by a rule found in the Foreign Direct Investment and Foreign Capital Inducement Act, which went into effect in February 1997.²⁴² Though the Act applied only to foreign direct investment, it was possible for investment in a listed firm to be governed by the Act. The definition of foreign direct investment involved management control over the target. If a foreigner acquired 10% or more of a domestic company (listed or not), and the facts demonstrate the foreigner's intention to exercise actual control over the management of the Korean firm, the investment was governed by the FDIFCIA.

The Act required that the prospective foreign buyer obtain target board approval if he intended to acquire 10% or more of the target's shares. In response to criticism of the rule, the threshold was raised to 33% in February 1998 and was abolished in May 1998.²⁴³ Beginning April 1, 1997, SEA section 21(2) required a "mandatory tender offer." If the acquirer contemplated acquiring 25% or more of the shares in a listed company, the acquirer had to acquire at least 50% plus one share of the target by public tender offer. The effect, if not the original intent, was to increase the cost of a tender offer and to deter them by making them expensive. In response to criticism that the rule was out of step with the national policy to encourage foreign equity investment in cash strapped Korean firms, the requirement was abolished, effective March 1, 1998.

DEFENSES

While there have been only a handful of hostile tender offers,²⁴⁴ some firms have erected various defenses and the law has been changed to allow this. The chaebols had been barred from making large investments in other firms, as a means of slowing the concentration of power in the chaebols. Members of the top thirty chaebols were allowed to invest in other firms only to the extent of 25% of the investor's net worth.²⁴⁵ The limit was abolished in exchange for allowing hostile M & As.²⁴⁶ Such investments can be used to buy shares that might otherwise be purchased by an outside investor. But cross shareholdings were

(last visited Dec. 19, 2000) (noting limits imposed by Electricity and Communications Business Act and General Banking Act.) The purchase of shares in a defense firm is subject to special review under article 6(3) of the FIPA.

242. The FDIFCPA was replaced by the Foreign Investment Promotion Act in Nov. 1998.

243. See Foreign Direct Investment & Foreign Capital Inducement Act § 8-2(1) (1997) (S. Korea).

244. A recent article notes only three cases. See Kim, *supra* note 74 at 312 & 315.

245. This rule was lifted in February 1998.

246. See *Seoul Shields Chaebol from Hostile Bidders*, INT'L HERALD TRIB., Feb. 5, 1998, at 15.

one of the ways that the chairman held his control over the group and in its trial and error efforts to regulate the top thirty chaebols, the government will reinstate the cap on investment in affiliates, effective April 2001.²⁴⁷ Another relaxation of the law allows any publicly traded firm (KSE or KOSDAQ) to acquire treasury shares. The Commercial Code generally prohibits a firm from acquiring its own shares on its own account,²⁴⁸ but the SEA specially grants this right to public companies. The number of permitted treasury shares had been limited. In 1996, the limit was 5%, raised to 10% on February 12, 1996, raised to one-third on February 24, 1998 and finally eliminated on May 25, 1998.

In response to the possibility (if not threat) of a hostile tender offer, Korean firms are reported to have undertaken various defensive measures.

Some have changed bylaws to reduce the number of board members and buy back shares, while others sought to recruit friendly shareholders via share options and private equity placements. Korean Air changed its bylaws to bar foreigners from becoming a chief executive officer at its March (1998) shareholders meeting. SK Securities, for instance, nearly doubled the ownership held by the chairman of the SK Group, the fifth largest chaebol, to over 26% in February (1998). Conglomerates such as LG and Daewoo have issued low quality convertible bonds to stave off foreign investors and have their affiliates assume the bonds, a move criticized by the Securities Supervisory Board.²⁴⁹

The Pohang Iron & Steel Corp., POSCO, adopted an amendment to its articles of incorporation to provide for the issuance of convertible preferred shares.²⁵⁰ Youngone Corp., a clothing maker, issued 430,000 new shares, or 10% of total equity, and distributed the shares among affiliated firms.²⁵¹

There are not yet any decided cases that determine whether these defenses are consistent with the new fiduciary duty of directors.

247. See *supra* note 132.

248. See COM. CODE art. 341 (S. Korea).

249. *Investing, Licensing & Trading*, *supra* note 53 at 16.

250. See *POSCO to Introduce Global Professional Management System*, KOREA ECON. DAILY, Mar. 1, 1999; *News Brief*, POSCO, Mar. 20, 1999 (stating that "the company introduced the basis for issuing convertible preferred shares as a method for ensuring stable management.")

251. See *Blue Chip Firms Exposed to Hostile Foreign M & As*, KOREA HERALD, Feb. 10, 1999, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

CONCLUSION

Our focus has been on the board of directors because that is where shareholder value should begin. The available evidence suggests that the boards of large Korean companies have the legally required audit and nominating committees and complement of outside directors. Little would be gained by blatantly disregarding the law. But the game can still be rigged, particularly if an autocratic founder/chairman is at the helm. An extensive vetting process assures that no renegade will sit at the table. There will be some binding social connections, such as the same high school or hometown. These are the ties that bind in Korea, where one survives by being loyal to one's family, peers and leader.

Even without a founder/chairman, management has significant control over the appointment of directors. CEOs often dominate, directly or indirectly, the director recommending or appointing process, and tend to recommend director candidates who are more inclined to support their decisions. Outside directors are not socially independent. Indeed, "no definition of independence yet offered precludes an independent director from being a social friend of, or a member of, the same clubs, associations, or charitable efforts as, the persons whose [performance] he is asked to assess."²⁵² There have been some studies of the background of the outside directors appointed thus far. It would be worthwhile to have a closer look at their curricula vitae, especially at the large firms, to know how many have high school or hometown or other social connections with members of the founder's family. If a true outsider were present, why should anyone listen to him? The law does not explicitly require that and shareholder suits are rare in Korea. Recourse to the courts is still not the norm.²⁵³

252. Victor Brudney, *The Independent Director - Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 613 (1982).

253. "Reliance upon law is alien to thousands of years of Confucian teaching, which continues to course through contemporary Asian veins. Even at the level of ordinary persons, the most popular expression toward an upright neighbor or a good colleague today is 'a person who can live without law'. One's insistence on the formal law tends to make a Korean frown upon him. Litigation, in short, is not the prescribed social remedy for a dispute. Even when lawsuits are filed, they are very differently understood and managed in the code law jurisdictions of East Asia. A civil suit once filed generally results in the first hearing in a month or two, and this hearing is normally set for an hour or two for the purpose of hearing one witness. Questions to be put to the witness (direct and cross) are written out in advance and exchanged between counsel and the court. Then the matter will be continued for another three or four weeks, at which time another witness is heard for another hour or two. After several witnesses and months have elapsed, the court will call in the attorneys and inquire as to why the matter is not settled yet. This judicial process is effectively designed and employed to promote reconciliation and the reconstruction

If the mission of the outside director is to ask the tough questions and to press for correction when there is need, what happens if personal confrontation would violate ancient social norms? The prevailing culture has been one of obedience to a strong leader and we wonder whether the reforms will make a difference in the culture of the boardroom. This is an empirical question and it should be possible to determine an answer. For example, we are curious to know whether any director of any chaebol firm has ever cast a dissenting vote. The absence of any recorded dissent in any single firm would not, by itself, be absolute proof of a lack of independence. A consistent pattern of unanimous voting might mean only that directors worked out their disagreements before a formal vote. The board may have conferred, debated and resolved their differences through compromise. But if the board of every chaebol firm has always decided matters by unanimous vote, there is a strong inference of domination by the chairman.

Another way of considering this is to look at the articles of incorporation of the chaebol firms. How many of them provide for more independence than the law requires? How many firms that are not required to do so have audit or nominating committees? How many firms have compensation committees, which the law does not require at all? How many firms allow for cumulative voting?

There has been some change in the governance of the chaebols. The chairmen are no longer visibly directing the day-to-day affairs of the groups and appear to be letting the managers do their jobs. The notable exception has been Hyundai, which has occasionally been treated like a leper by foreign investors. And even there, the founder/chairman recently announced his retirement. The group was in a liquidity squeeze. Creditors had demanded that Mr. Chung give up management rights and investors were dumping its stock.²⁵⁴ The legal reforms may have played a role here.

of relationships without the application of legal judgments. The adversarial understanding of western jurisprudence does not apply. The legal role generally assumed by East Asian lawyers is much more conciliatory in nature — the view being that the paramount function of legal counsel is to identify some common ground which the contracting or disputing parties can comfortably share. Arranging a lunch or finding a trusted intermediary to explain differences will often go farther than a issuing a demand or a petition.” *Law, Advocacy & Life (Insurance) in Asia*, ASS’N OF LIFE INSURANCE COUNSEL, Presentation at The Green Brier, White Sulphur Springs, West Virginia (May 23, 1995); “There have been only a few reported shareholder derivative suits.” Kim, *supra* note 74 at 283.

254. See *S. Korea Tries to Calm Local Markets Amid Fears Over Hyundai’s Liquidity*, FIN. TIMES (London), May 29, 2000, at 1 available in LEXIS, News/By Individual Publication/F Library, FINTME File; *Hyundai at Height of Liquidity*

The banks played a role as well. The insolvency of the large Korean banks brought about their sale in whole or in substantial part to foreign investors. Westerners now sit on the boards of the banks and this has meant a reduction if not the complete end, of easy credit. The banks now evaluate the creditworthiness of the borrower and the merits of the borrowing. The Financial Supervisory Service is now considering whether to require that the banks, as lenders, shall take the extent of corporate governance improvement into account when reviewing the lending.²⁵⁵ The banks have reduced credit lines to companies with poor corporate governance, stopped financing unprofitable projects and required the chaebols to enter into financial improvement agreements with them. It does not displease the banks to see a borrower with an independent board of directors.

This is not to say that the chairman has been eclipsed altogether. He may still be pulling the strings in the appointment and removal of directors and officers. We should remember that no chaebol firm reformed itself until the government ordered it and the markets forced it, and no chaebol chairman has praised the virtues of an independent board to counsel and guide the affairs of the enterprise.

As long as the founders' families see no advantage to an independent board, compliance will be superficial. Corporate governance matters should be disclosed in corporate reports and filings from this year. It is now understood in Korea that institutional investors and foreign investors make their decisions based on independent boards and the treatment of minority shareholders, among other things.²⁵⁶ There are signs that the market has begun to dictate corporate behavior in Korea and companies that ignore the market's demand will not survive. Investors were upset by the family feud in the Hyundai group. LG Chemical bought stock in unlisted companies owned by the controlling family at unwarranted prices, and then had to announce at an investor relations meeting that it would henceforth abstain from

Problem, KOREA ECON. WKLY., June 5, 2000, available in LEXIS, News/By Individual Publication/K Library, KECOWK File; *When is Hyundai Going to Get It?*, BUSINESS WEEK, June 12, 2000, at 66; *Hyundai Signals Sweeping Change*, KOREA ECON. WKLY., June 12, 2000, available in LEXIS, News/By Individual Publication/K Library, KECOWK File; *Family Ties, Money Troubles, Politics and Old Fashion Ambition Cloud Hyundai's Future*, ASIaweek, June 16, 2000.

255. See FSS, *Reflecting the Corporate Governance Improvement When Reviewing the Lending*, DONG A ILBO, June 5, 2000.

256. See *Corporate Governance Improved, Corporate Value Increased*, DONG A ILBO, June 19, 2000.

stock trading with the founder's family.²⁵⁷ The Samsung group similarly undertook a series of unusual transactions with the chairman's son.²⁵⁸ Worse, it has been alleged that Samsung Electronics paid bribes to at least one of its outside directors.²⁵⁹ Share prices of Samsung companies have fallen in 2000, reflecting investor distrust of the group. Should companies with better management enter the system, the chaebols will see smaller inflows of investors' resources. This should add more pressure on them to change their behavior. In the end, the banks and the stock markets will bring real reform to the chaebols, even if outside directors do not fulfill their envisaged role.

257. See *LG Group Owner Family Learns Lesson from Samsung Chairman's Stock*, KOREA HERALD, May 12, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.

258. See *supra* text accompanying note 152.

259. See *Bribery Scandal Deepens Investor Distrust of Samsung Electronics*, KOREA HERALD, August 26, 2000, available in LEXIS, News/By Individual Publication/K Library, KHERLD File.