CORPORATE GOVERNANCE REFORM IN KOREA: AN APPRAISAL

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"Corporate governance refers to 'the relationship among various participants in determining the direction and performance of a corporation.'"

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Among the many changes that occurred in the Korean economy since the IMF bailout program started, the reform in corporate governance can be considered as one of the most significant changes. The widespread reform in corporate governance came about because one of the causes of Korea's economic crisis often cited has been the ineffective governance system. The McKinsey Global Institute (1998) reported that the system "was not able to monitor the firms' behavior properly, allowed the firms to borrow excessive debts from the domestic and foreign financial institutions, and allowed them to invest lavishly in the business areas that did not create value."

What is Corporate Governance?

Corporate governance refers to "the relationship among various participants in determining the direction and performance of a corporation." The primary participants are: (1) the shareholders, (2) the management (led by the CEO), and (3) the board of directors[1]. In other words, it is a mechanism which disciplines the management in firms where the residual claims and residual controls are separated.

In general, disciplinary methods in corporate governance can be separated into two areas: (1) market discipline (i.e., capital market, financial market, commodity market, and labor market), and (2) internal discipline (i.e., business organization, board of directors, and relationship investors). These methods aim to accomplish both transparency and accountability in the corporate management.

Changes in Corporate Governance since the IMF Bailout Program

As can be seen in <Table 1>, many measures have been introduced and carried out in order to improve the corporate governance. That is, by way of enhancing both transparency and accountability, the Korean government is trying to establish an efficient monitoring system for corporate management. In summary, current measures are very helpful in establishing corporate governance, which virtually has not been present until now. Furthermore, while shareholder activism has been flourishing, it has become a general trend around the world to manage a firm based on the objective of maximizing shareholders' value.

Due to this trend, lots of changes have been made inside firms as well. That is, minority and foreign shareholders have made some high-level demands to firms' managements to change their "bad habits" so as to increase profitability.

A landmark court ruling has created an impetus for more shareholders' suits against corporate executives. The Seoul District Court in July this year ordered four former executives of the Korea First Bank to pay US$31 million in compensation for financial losses the bank suffered from their poor management. The actions

1) Monks and Minow, *Corporate Governance*, Blackwell Publishers, Cambridge, MA, 1995, p.1.

were made by shareholders with the assistance of a civil right activist group who has now started a campaign against big business groups' poor management. The unprecedented ruling is expected to open the door for other small shareholders of corporation.

Furthermore, along with the full liberalization of the capital market, foreign equity ownership[2] has played a key role in stimulating efficient corporate governance, which has been virtually non-existent before the IMF era. For instance, the Tiger Fund, with 6.51% of SK Telecom's shares, together with the Korea Fund and Oppenheimer Fund demanded that SK Telecom assign two outside directors and also provide higher dividends. In addition, because of their requests, large-scale investments or inside trades among SK group affiliates now

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〈Table 〉 Changes in Related Laws on Corporate Governance

Policy	Content
Transparency in Management	- Adoption of combined financial statements (FY '99) - Following international accounting principles ('99) - Prohibiting new cross debt guarantees (4/98) - Resolution of existing cross debt guarantees (3/2000) - No demand for new cross debt guarantees from financial institutions - Strengthening the responsibility of external auditors and accountants
Capital Market (M&A)	- Full liberalization of hostile M&A by foreigners - Elimination of the ceiling on foreign equity ownership - Abolition of compulsory tender offer regulation
Financial Market	- Establishing a business monitoring system by banks - Strengthening a new loan check system
Corporate Governance	- Strengthening the legal liability of controlling owners by designating them as 'de facto directors' - Legislating directors' fiduciary duty - Allowing voting rights of institutional investors (6/98) - Strengthening voting rights of minority shareholders (5/98) (Reducing representation requirement for minority shareholders' suits to 0.01%) - Introducing shareholder's proposal right (5/98) - Compulsory appointment of outside directors (1/98) (To be extended to more than 25% of all members from '99) - Establishment of external auditors committee - Introducing a cumulative voting system (2000) - Legislating securities class action for false financial statements ('99)

2) With the full opening of the capital market, foreign institutional investors have obtained about 15% of all listed companies' stocks.

require prior permission from the board of directors.

Problems in Current Trends

However, the current trends in corporate governance have brought in many negative effects as well as positive effects. As of now, too many monitoring mechanisms have been hastily instituted, surpassing the general level of the corporate systems in advanced countries on average. While this is somewhat understandable considering the virtual non-existence of any corporate governance in the past, it could bring about many undesirable side-effects from the management's viewpoint.

First of all, improvement in corporate governance should be directed more by market discipline than by internal discipline. Since market discipline (capital market and other various markets) is basically more efficient than internal discipline, it is not a good idea to build and focus on internal discipline such as the organization in the board of directors and the firm's inside structure.

Second, it is expected that there will be a surge in lawsuits by minority shareholders against the management because of its allegedly wrongful acts. In Japan, when similar lawsuits were easily possible in 1993 after the drastic reduction in plaintiff's lawsuit expenses, the number of lawsuits by minor shareholders sharply increased from 31 ('92) → 84 ('93) → 145 ('94), → 174 ('95). Since this trend is also similar to United States, both countries are seeking to find some methods to curb the trend.

Third, precautionary measures are necessary before introducing and actively using both securities class action and cumulative voting systems, which will be legislated in 1999. In the event that plaintiffs win in a securities class action, the compensation is directly paid to shareholders, unlike in minority shareholders' lawsuits where the compensation is paid to the company. Thus, it is possible for firms to be excessively sued by shareholders with bad pecuniary motives. Furthermore, both class action suits and the cumulative voting system are rare in advanced countries.

Desirable Direction for Efficient Corporate Governance

The objective of implementing corporate governance is to strengthen efficient monitoring and control relative to management so that the purpose of a firm can ultimately be to increase its shareholders' value. Even the OECD, in a recent report (1998), emphasized that "there is no single universal model for corporate governance and that experimentation and variety should be encouraged." According to the OECD, two minimum standards to improve fairness, transparency, and accountability and responsibility in corporate governance are (1) shareholders' value maximization and (2) enhanced monitoring capabilities and independence of the board of directors.

While it is important that shareholders' value and rights be carefully considered, a gradual approach for building the right corporate governance system without incurring bad side-effects should be adopted. In advanced countries such as U.S., since the measures are developed over decades, there have developed some kinds of protection or control systems which have been gradually developed to prevent the measures being excessively abused. For instance, a Business Judgment Rule, which is often used as a basis for a judge's decision in lawsuits in the U.S., should be carefully applied whenever court has decided whether sued directors or officers commit wrongful acts. The rule implies that any directors or officers who are disinterested, independent, and informed based on sufficient information are not liable to be sued even though their decisions are turned out to be erroneous ex post. Currently, though, in Korea, it is not likely that the judge's decisions in the forthcoming lawsuits will be based on the rule, since experience and judgments on such lawsuits by minority shareholders are minimal.

Another potential problem is the requirement for all listed companies to increase the number of outside directors to more than 25% of board members by 1999. This means that some two thousand very qualified people will be needed for the job within a year.

Conclusion

There is no doubt that Korean conglomerates should enhance their corporate governance in order to monitor the CEO and other executive officers efficiently and effectively. However, to the extent that too many governance measures are being hastily introduced in a short time, it might be difficult to get desirable effects right away. Therefore, it is wise to consider thoroughly both the benefits and costs from the viewpoint of society as a whole when introducing a new law for governance.

It is widely perceived that Korea has developed ownership and management structures which are different from those of international standard. In the U.S., for example, where ownership and management are completely separated, governance measures are instituted very early in order to reduce the agency problem between shareholders and management. However, in Korea, where the separation is not fully made and equity ownership is not widely spread, it is desirable to introduce the new system step-wise. VIP

1999 Revised Forecast *M.K. Jun*

(Cont'd from p. 18)

Private consumption will increase only 0.5%, while the total consumption will increase 1.0% due to the government consumption increase stemming from the expansionary fiscal policy. Both facility and construction investment will show sluggish recoveries, showing 0.7% and 3.4% rises respectively. Exports will show a very slow recovery of 0.6% since during the first half, it is hard to expect that export markets will improve. Imports will increase 14.9% to make up for the excessive drops in inventories of raw materials and production facilities in 1998. But the rate of increase in imports is lower than in the previous forecast.

Consumer prices will be stabilized at 2.1% due to the relatively stable exchange rate and the sluggish aggregate demand. Interest rates are also expected to be stabilized in 1999. In fact, the government's strong intention has forced us to revise our forecast—we expect the interest rate will stay around 9.5% by the end of 1999. The won/dollar exchange rate will be 1,250 in 1999 due to the continuous current account surplus and foreign capital inflows. The number of unemployed will increase in the process of corporate restructuring, with our estimated unemployment rate being 8.0% in 1999. VIP