

# A Challenge for Corporate Governance in Korea: Tragedy of "Ownerless Firms"

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# Introduction

- What is Corporate Governance Change?
- Controlling Minority S/H(CMS) Structure
- Corporate Governance and Political Environment
- A Problem of Corporate Governance Change? – Tragedy of “Ownerless Firms”
- Conclusion

# Corporate Governance Change

- Debate as to convergence vs. path dependence in corporate governance
- Q: How do you measure the change in corporate governance?
- A: The most fundamental criterion seems to be the purpose for which firms are actually managed.
- It is difficult to grasp from outside such purposes of firms.

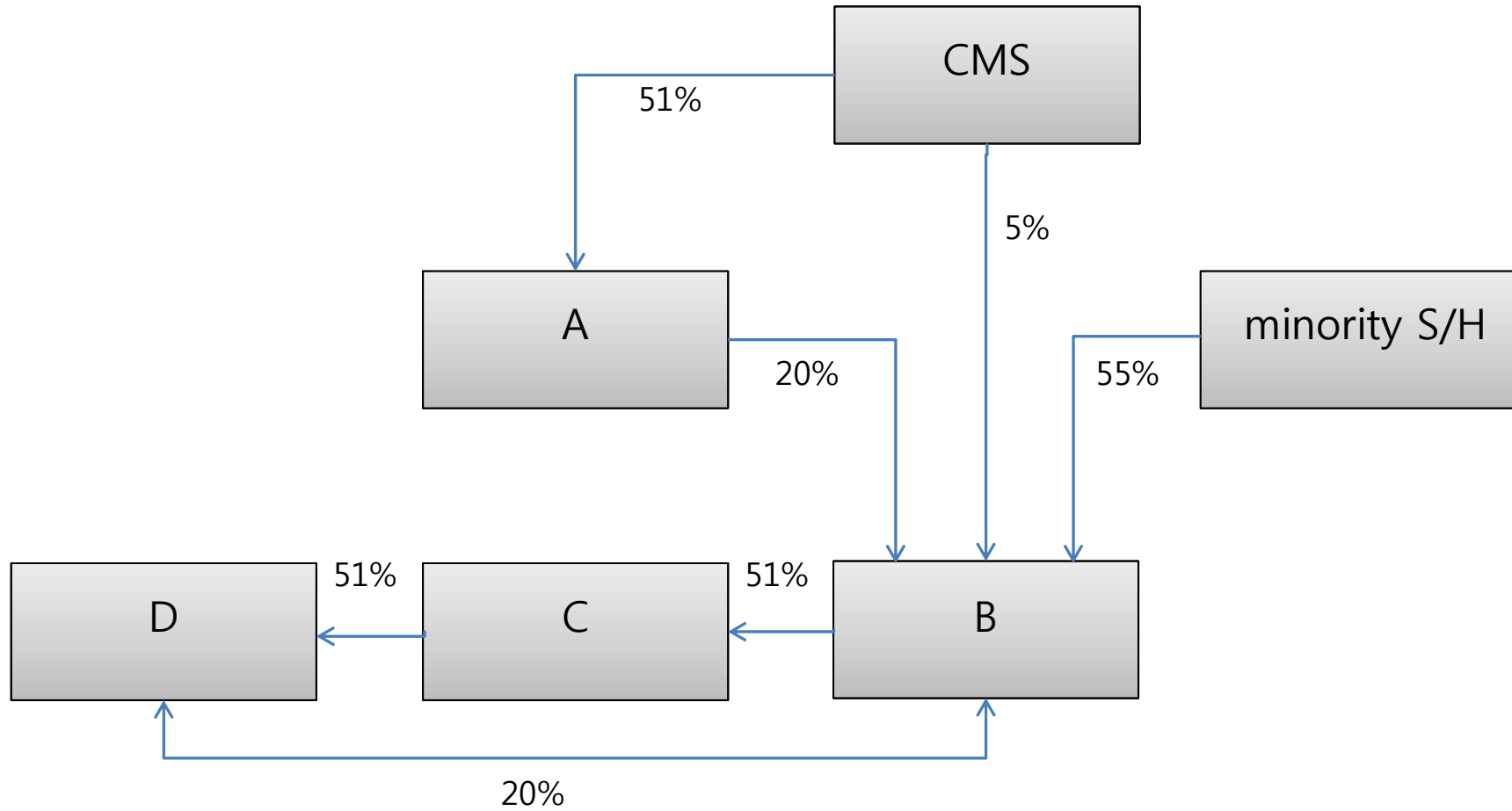
# Corporate Governance Change

- Instead, it is easier to identify those who control a firm.
- Depending on who controls a firm, the firm's behavior may differ.
- In identifying a controller, the share ownership structure is crucial.
- Ownership structure -> controller -> firm's behavior

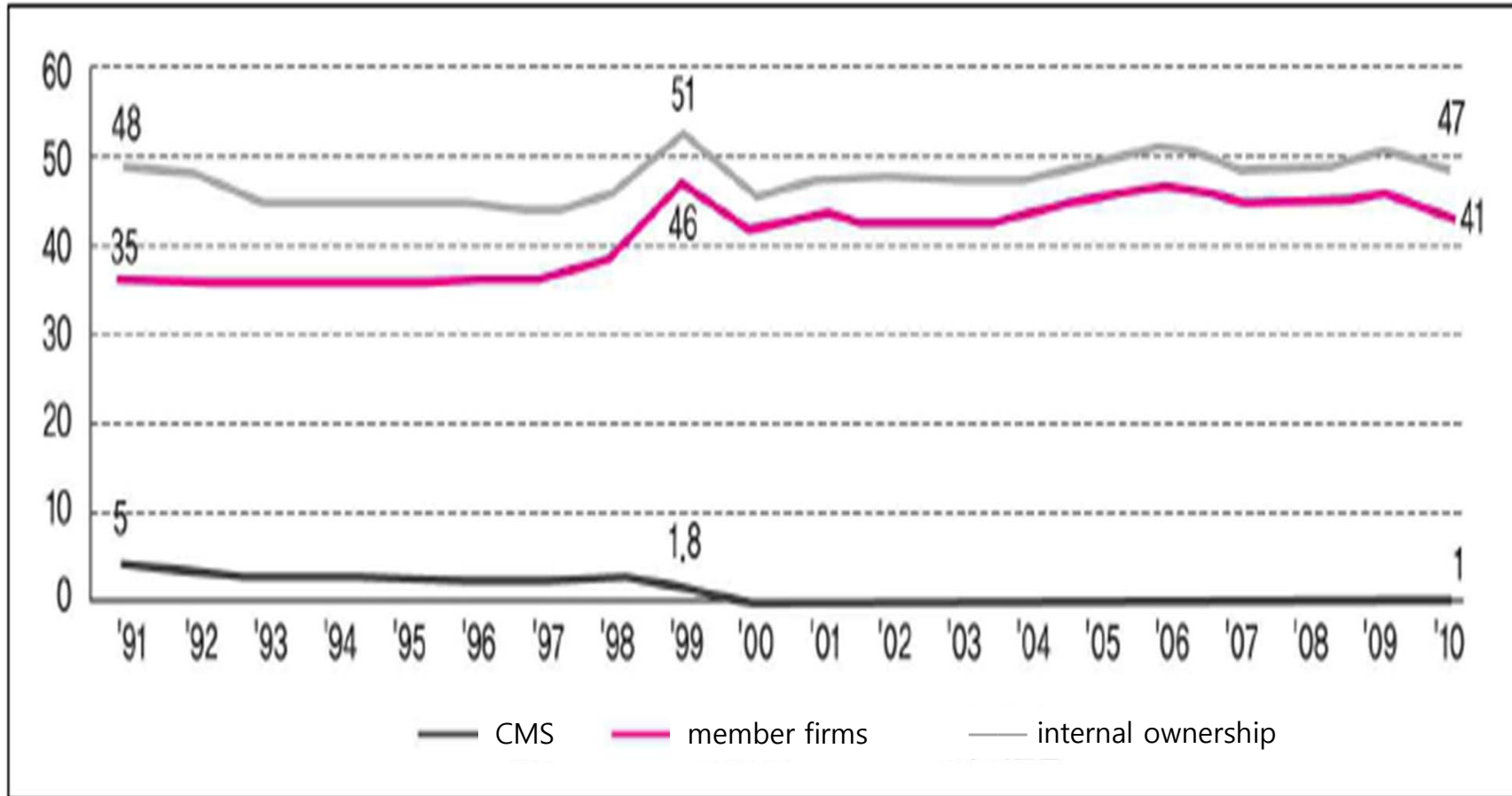
# CMS Structure

- The ownership structure of large Korean firms is often characterized as controlling minority shareholder (CMS) structure.
- A controlling minority shareholder effectively controls the whole group of firms with the help of inter-company shareholdings.

# CMS Structure



# Stability of CMS Structure



# Problems of CMS Structure

- With no plan to sell his shares, CMS is interested not in share price, but in the long-term growth.
- Entrenchment effect – long-term perspective vs. tunneling
- It is difficult to determine the effect of the CMS structure on performance.



# Corporate Governance & Political Environment

- Corporate governance change, especially a change affecting the ownership structure, may take place only when the political environment supports it.
- Given the predominance of *chaebol* in most fields of society, a fundamental change in ownership structure is difficult, if not impossible, to achieve.

# Political Environment

## Allies

- Managers and employees
- Suppliers and distributors
- Government
- Media
- Politicians
- Academia etc.

## Enemies

- NGOs
- Liberal intellectuals and politicians
- General investors, including foreign investors

# Changes in Political Environment

- Growing general antipathy toward *chaebol* owners
- Causes:
  - - unfair business practices related to dynasty-like succession
  - - growing gap between the rich and the poor (*chaebol* firms and small and medium size firms)
  - - Negative happenings

# Unfair business practice - old

- Issuance of equity securities to heirs of CMS at unfair prices – Samsung Group
- Some of those involved in this kind of scheme got convicted.
- Chairman Lee of Samsung Group narrowly avoided conviction by the 6-5 decision at the Supreme Court.

# Unfair business practice – recent

- Corporate opportunity + self dealing
- 1. X, a son of CMS, sets up a new firm Y
- 2. all the member firms exclusively deal with Y at unfair(or apparently fair) prices
- 3. Y goes public
- 4. X secures the control block in the parent company with the funds from the IPO
- Ex. Hyundai Motor Co. Group (An investment of \$3 million has grown to about \$2 billion in 11 years.)

# Controversial business practices

- It is a wide-spread practice for heirs of CMS to engage in business activities with the expectation of the group support.
- Some daughters of *chaebol* had to move out of the bakery business due to the public criticism that they drive independent bakery shops out of business.

# Political Environment – election

- 2012 is the year of the election: general election in April and the presidential election in December
- Politicians turn to this issue to seek votes
- - regulating inter-company shareholding
- - encouraging the National Pension Fund to play a more active role in corporate governance

# Tragedy of “Ownerless Firms”

- Even among large listed firms, only a handful of them have no individual controlling shareholder. These firms are often called “ownerless firms”
- Most of ownerless firms are former government-owned firms which have gone public as a way of privatization.
- Most financial holding companies with bank subsidiaries have no controlling shareholders.



# Tragedy of Ownerless Firms

- POSCO: steel manufacturer
- KT: telecom firm
- KT&G: tobacco and ginseng firm
- KB Financial Holdings
- Shinhan Financial Holdings
- Hana Financial Holdings

# Tragedy of Ownerless Firms

- Ownerless firms are supposed to be run by professional managers elected by the board.
- The board of directors is in turn composed primarily of outsiders.
- Most of them have been enjoying an excellent reputation in terms of corporate governance.

# Tragedy of Ownerless Firms

- CEO changes in all these firms after the change of government in 2008
- Most of the changes occurred in awkward situations.
- CEO of KT resigned as he was indicted for taking bribes from the CEO of its subsidiary.
- CEO of POSCO stepped down in the middle of his term, and a close aide to President Lee is reported to have influenced the succession process.

# Tragedy of Ownerless Firms

- Growing concern that these ownerless firms turn into spoils of the power elites.
- Ownerless firms may provide job opportunities and business opportunities.
- CEO change may occur whenever there is a change in political leadership.

# Tragedy of Ownerless Firms

- If such phenomenon continues, the ownerless firms will likely stagnate due to the so-called “tragedy of commons”.
- As long as the tragedy of ownerless firms is not reined in, it may not be wise to turn *chaebol* firms into ownerless firms.

# Conclusion

- The tragedy of ownerless firms is a part of a bigger problem of ownerless institutions in Korea.
- Ownerless institutions rarely succeed in Korea. An owner often exists even in non-profit institutions, such as churches, universities and hospitals.
- While people are critical of *chaebol* owners, they generally believe that an ownerless institution will rarely succeed.

# Conclusion

- It is difficult to change the existing CMS structure into a widely dispersed ownership structure.
- It seems even more difficult for ownerless firms to compete adequately with *chaebol* firms.
- A challenge for Korea is how to secure an environment that enables an ownerless firm to operate efficiently without falling prey to the power elites.

# Conclusion

- Emergence of successful ownerless firms (and institutions) may be regarded as evidence that Korea has actually joined the ranks of advanced countries.



- Thank you very much!