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by Kenneth Scott
Stanford University Law School

THE ROLE OF CORPORATE GOVERNANCE IN SOUTH KOREAN ECONOMIC REFORM

by Kenneth Scott,
*Stanford University Law School**

At the beginning of 1997, the "Asian tigers" had achieved decades of remarkable growth, and they were being held up as models for the rest of the less-developed world to follow. Their economies typically combined elements of both business free enterprise and governmental control of investment, usually exerted through the banking system. The ruling politicians directed the banks' lending policies and even individual decisions; the banks received implicit government (central bank) guarantees; the favored borrowers could expand rapidly, if not necessarily prudently; and the politicians received large contributions from the favored firms. It was a system exemplifying not Western-style party democracy and checks-and-balances, but "Asian values" of hard work, social order, and deference to authority.

The second half of 1997, however, subjected the concept of a new Asian model of economic development to a series of severe tests. Beginning in July, first Thailand and then the Philippines, Malaysia, and Indonesia were forced to abandon their attempts to control exchange rates, and to let their currencies float (and sink) in the open market. Companies and banks with large amounts of short-term, foreign-currency-denominated debt quickly saw themselves confronting bankruptcy. The most recent, and most important, addition to this list is South Korea. In December the International Monetary Fund responded with a $57 billion loan and credit assistance package, which soon had to be supplemented with efforts to obtain another $10 billion in new credit from an international consortium of private banks.[1]

The causes and consequences of this series of Asian economic crises will be examined and debated for some time to come, and of course there are meaningful differences from one country to another. Whether the outcome will be significant and lasting reform in the way some of these economies are run remains to be seen, despite the conditions attached to IMF assistance programs. As with all bailout programs, the problem is that they also tend to perpetuate flawed institutions and relieve borrowers and lenders from some of the losses resulting from their decisions. In this respect, market discipline is undermined. But if there is such reform, one—among many—of the ingredients that will have to be considered is a change in the system of corporate governance for banks and business firms. Such large enterprises are now often run more in the interest of the government and the controlling shareholder group than in the interest of efficiency and maximizing aggregate shareholder wealth.

This article will examine that general proposition in terms of the structure of corporate governance in South Korea. The IMF Staff Report on the Korean situation noted that "there is an urgent need to improve corporate governance and the corporate structure."[2] The rest of this article falls into four sections. The first discusses the threshold issues of why and when corporate governance is significant. The second looks at how corporate governance institutions function in different countries, focusing primarily on the United States, Japan, and Germany. The third undertakes to develop from the comparative analysis some criteria by which to appraise corporate governance systems. The fourth and concluding section applies the analysis specifically to South Korean institutions and attempts to evaluate the reforms now being suggested.

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1. "Foreign Banks May Lend $10 Billion to Seoul," *Wall St. Journal*, Dec. 30, 1997, p. A6.

2. International Monetary Fund Document, "Republic of Korea—Request for Stand-By Arrangement," Washington, D.C., December 3, 1997, p. 15, ¶51.

WHEN AND WHY CORPORATE GOVERNANCE IS IMPORTANT

To make a coherent analysis of a set of corporate governance institutions, it is necessary to specify the objective being sought. Modern corporations, to take advantage of technological progress and scale economies, are large organizations requiring heavy capital investment. The amounts of capital required often can be raised only by pooling the savings of a multitude of investors, who must rely on others to manage their investments and run the enterprise. The institutions—the particular set of legal rules, incentives, and behaviors—that support and underlie that reliance by investors constitute the system of corporate governance in a given society.

In this paper I will assume that the objective is to maximize the economic efficiency of the firm. Discussions of corporate governance sometimes appear to be addressing other concerns—such as monopolistic or oligopolistic power, the welfare of particular constituencies, or macroeconomic stability. Those are all valid issues, but the design of corporate governance is not a very direct or effective way to deal with them. It has a real and important contribution to make to economic efficiency, but only a tangential bearing on numerous other matters.

It should be noted that other institutions and forces also come to bear on the operations of the firm, pushing it toward greater efficiency. Foremost among them are the pressures that arise from competition in the product and factor markets. Perfect competition, domestically and internationally, would work to eliminate this and many other problems, but in its absence corporate governance continues to be a matter worth attention.

In terms of economic efficiency, my focus will be on the cost of external equity capital to the firm—the price, in the sense of expected returns, that the firm must offer outside investors to get them to buy stock in the enterprise. Why are shareholders willing to turn large sums of money over to other people (managers) to invest in specialized assets on very ill-defined terms? The managers of the firm do not tell them when they will get their money returned or what compensation will be paid for its use. Others who furnish inputs to the business are not so vague about arrangements for payment.

Why are shareholders' property rights so poorly defined? The usual answer is that the stockholders' essential function necessitates that condition. They are the bearers of the residual risk of the firm, enabling others to contract with it on more definite terms; their claims come last, after all other various contingencies and claims are satisfied, and hence it is impractical to try to spell them out in detail under all states of the world. The status of stockholders provides a paradigm of the (highly) "incomplete" contract. As such, it leaves the stockholder potentially quite vulnerable to managers acting incompetently or in their own interests.

If the position of stockholders cannot be well protected by contract, then how is it made viable? There are two principal mechanisms that serve this function. One is law: fiduciary rules that require managers (agents) to act in the best interests of stockholders (principals). The other is governance: a set of provisions that enable the stockholders by exercising voting power to compel those in operating control of the firm to respect their interests. Legal fiduciary rules can best address relatively clear conflicts of interest; issues of managerial competence, except in egregious cases, fall in the domain of governance.

Obviously, corporate governance is not a problem for the 100%-owner-manager of a business. Nor is it much of a problem for the majority stockholder (or group) which controls the board of directors and can fire the managers at any time. (Protection for minority interests in such a firm will have to come primarily from fiduciary rules, since their voting power is generally ineffectual.) So corporate governance is an issue mainly for minority stockholders in companies that are controlled by the managers and where there are no significant stockholders that can easily work together. In that situation, the stockholders potentially can still exert control through the board to protect their interests, but they face formidable difficulties (in terms of transaction costs and inadequate incentives) in acting together and actually doing so.

In a practical sense, therefore, corporate governance is important as a means of reducing the "agency costs" imposed by managers acting in their own interests to the detriment of shareholders, mainly, again, in firms owned by dispersed stockholders. How large a concern is this? That depends on the prevalence of such firms in the economy, and hence will vary across countries. Reliance on external equity finance displays a wide range, from firm to firm and nation to nation. The explanations for that range constitute one of the major areas of

controversy and investigation in the field of corporate finance and governance.

A starting point is to inquire why a firm would wish to rely on external equity finance at all. The usual answer is that it is cheaper to finance through the stock market because portfolio investors can diversify away the "non-systematic" or firm-specific risk, and the issuer thus pays a risk premium only for the systematic or remaining risk. Stock market equity is also believed by many to reduce the corporate cost of capital by opening up the potential supply of capital. A lower cost of capital for the firm (or a nation's economy) in turn increases, *ceteris paribus*, profitability, economic growth, and international competitiveness.

But recourse to public capital markets also means greater exposure of owners to agency costs, and thus greater need for corporate governance institutions and rules to limit the extent to which managers can mismanage the firm, divert wealth from shareholders, and extract "control rents." If the objective seems desirable enough, then what is controversial? How best to achieve it.

A BRIEF OVERVIEW OF INTERNATIONAL CORPORATE GOVERNANCE SYSTEMS

Since all countries and economic systems face the problem of how to economize on principal-agent costs, one approach to an answer is to look around the world and see how it has been dealt with. The comparative approach, which has attracted considerable attention over the last decade, focuses on the three largest and most developed economies: the United States, Japan and Germany. Each has a distinctive set of institutions. A full description would be quite lengthy and go beyond the scope of this paper, but each is usually characterized in terms of an "ideal type" (even though it does not reflect the actual diversity and complexity to be found in each nation).

For the United States, the ideal type is the so-called Berle-Means corporation,[3] with equity ownership diffused among a multitude of small stockholders and a self-perpetuating management firmly in control under most circumstances. A degree of discipline over management is provided by the threat, and occasionally the reality, of proxy contests, hostile takeovers, and leveraged buy-outs. Legal rules also impose on directors and officers certain fiduciary duties—particularly the duty of loyalty—which "require" them in conflict-of-interest situations to act in the best interest of the stockholders rather than of themselves. That general admonition has received development in a number of recurring patterns, and is enforced through civil liability actions brought by attorneys on behalf of shareholders.

Underneath the ideal type lie many questions. How accurate is it for the U.S. economy? Institutional as opposed to individual investors now own almost half of the total U.S. equity market, but there are thousands of institutional investors (including pension funds, mutual funds, insurance companies, trust companies, foundations, charities and endowments). How much less acute is *their* collective action problem? In the 25 largest U.S. corporations, on average 27.5% of the common stock is held by the top 25 institutional investors.[4] But, as capitalization size decreases, so in general does the institutional share (though exact data on this are lacking). And various financial and securities statutes impose a set of technical legal impediments to significant holdings and coordinated action by institutional investors, although the latter were somewhat eased in 1992.

As for fiduciary duties, just how effective are they? There is a multitude of different rules for different contexts, ranging from criminal penalties for theft and embezzlement to civil liability for "unfair" self-dealing and to amorphous admonitions to treat minority shareholders with inherent fairness in a holding company formation. Enforcement also faces a collective action or free rider problem, handled with the devices of derivative suits and class actions, but the latter in turn have their own agency costs.

In Japan, the ideal type is the "keiretsu," thought of as a group of companies linked by stable cross-shareholdings and seller-buyer relationships. A parent company, or more often a main bank, is supposed to act as the administrator for the group, monitoring management performance of the member firms and intervening in cases of sufficient financial distress.[5] Non-member shareholdings con-

3. This designation comes from Adolph Berle and Gardiner Means's 1932 classic, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

4. Institutional Investment Report 1997, Vol. No.2 (New York: The Conference Board, 1997) p. 36.

5. See Masahiko Aoki, "Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View," in, eds., Masahiko Aoki and Hugh Patrick, *The Japanese Main Bank System* (New York: Oxford University Press, 1994).

If there is reform, one of the ingredients that will have to be considered is a change in the system of corporate governance. Large corporations in Southeast Asia are often run more in the interest of the government and the controlling shareholder group than in the interest of efficiency and maximizing aggregate shareholder wealth.

stitute a substantial minority of the ownership of most of the member firms; but the public shareholders are inactive investors, and discipline exerted through market mechanisms such as hostile takeovers is almost unheard of.

Again, there are questions as to the extent to which the keiretsu pattern describes the current Japanese economy. Much of the literature is descriptive and assertive, not numerical or empirical. The role of the main bank, which cannot itself own more than 5% in any company, was not much tested before the crash at the end of 1989. And, in part because of the propensity in Japanese accounting and bank supervision to conceal rather than disclose financial losses, the main bank system has not received definitive analysis since. It may be undergoing significant change, under current economic pressures.[6] With the main banks themselves in trouble, rescue operations for keiretsu members seem to have become hard to find.

The cross-shareholdings and transaction relationships are laden with potential conflict-of-interest dangers for the interests of outside stockholders, and it is not known how they have fared. The Japanese legal system does not rely on a general fiduciary duty of managers to act in the best interest of stockholders; instead, directors may be liable for gross negligence in performance of their duties, including the duty to supervise. The duty and liability run to the company, however, and enforcement by derivative suits is a relatively new phenomenon.

In Germany, the standard account looks at only a few hundred large firms, listed on the stock exchanges and operating under the two-tier (supervisory and management) board system required of companies with more than 2000 employees (who elect half the supervisory board). Major (over 25%) block-holders are common. Even more significant is the role of the firm's house bank and other banks in terms of their voting power. German banks, as universal banks, can own corporate stock, unlike U.S. banks. In addition, in a system of bearer shares, German banks are the primary depositaries for public stockholders and vote their proxies; the banks also run investment funds and vote those shares. The result is that banks in 1992 cast on average 84% of the votes at the annual shareholder meetings of the 24 largest widely held stock corporations.[7]

Does this mean that in Germany banks act as effective institutional monitors on behalf of shareholders? The answer is far from clear, since the same structure applies to the banks themselves. The five largest universal banks as a group cast between 54% and 64% of the votes in 1992 at their own shareholder meetings, though no one had an absolute majority at its own meeting. If the banks' managements are relatively unconstrained by other shareholders or the stock market, how is their discretion employed?

The legal system is not thought of as playing much of a role in German corporate governance. The civil law is not congenial to the broad fiduciary concepts of Anglo-American equity law. Supervisory board directors really do not have much decision-making responsibility, and co-determination has been criticized as undermining even its monitoring effectiveness.[8] Management board directors could act negligently or commit torts, but the institutions of the derivative suit or class action are unknown. For stockholders to sue management in such a situation, it would take a majority at an general meeting, or at least 10% to file a court petition; obviously it is a rare occurrence.

Suppose we leave the world of the most highly developed market economies and go to the world of the less-developed countries and emerging market economies. Now the typical pattern (to the extent the economy is not state-run) is one of companies closely held or dominated by a founder, his family, and associates. The role of external equity finance is small; the business is financed by retained earnings and heavily by debt (often on a political or subsidized basis from government-controlled banks). The effective constraints of the legal system on managers may be weak or non-existent, a condition which Russia at this point seems to exemplify.

What explains all these variations? We do not have convincing explanations, in part because we do not even have a good factual picture of corporate governance variables across the world. Of course, even in the absence of comprehensive information, one can speculate. There is a large political component in the generation of these different institutional

6. See Paul Sheard, "Financial System Reform and Japanese Corporate Governance," working paper, Baring Asset Management (Japan) Limited (1997).

7. See Theodor Baums, "Universal Banks and Investment Companies in Germany," in, eds., Anthony Saunders and Ingo Walter, *Universal Banking: Financial System Design Reconsidered* (Chicago: Irwin, 1996).

8. See Katharina Pistor, "Co-determination in Germany," working paper, Harvard Institute for International Development, 1997.

structures. Mark Roe, among other law and economics scholars, has demonstrated how the American antipathy to private concentrations of economic power led to statutes that geographically fragmented the banking industry and prohibited banks and insurance companies from owning stock.[9] Such restrictions, Roe argues, effectively prevented U.S. financial institutions from playing the governance role of their counterparts in Germany and Japan. Germany, in particular, had by the end of the 19th century developed large, nationwide universal banks with close relationships to industrial clients. As Roe also notes, however, the banks have both directly and indirectly stymied the growth of the public securities market, thus discouraging another potential source of corporate monitoring. In Japan, the goverment took control of the banking industry during World War II and used it to allocate capital to the industrial sector. After the war, with private capital exceedingly scarce, there was no significant stock market and government policy continued to be to finance industrial growth through bank debt, supporting the power of the main bank over its group of client firms. Such thumbnail sketches are not intended as explanations, but to suggest that understanding existing corporate governance systems goes beyond the pressures for economic efficiency to a consideration of historical "path-dependency" and other factors.

So which system is preferable? Is that even an answerable question? I have already mentioned the problem of data that are not available or have not been collected and tabulated. For no country, including the United States, can we paint a picture of the entire corporate governance structure. In comparative terms, no one has even attempted to go beyond a half dozen or so of the largest countries.[10]

But there are difficulties at a deeper level. How would one undertake to measure, in any rigorous way, the effectiveness of corporate governance across nations? How do you isolate and measure agency costs for an economy? In the 1980s, the tendency was simply to say that if economic growth rates in Japan or Germany had been higher than in the U.S., corporate governance was one of the factors at work and their systems might be better. If that pattern reverses over the 1990s, does the conclusion reverse? In the absence of good direct measures of corporate governance efficiency, some studies have resorted to the use of proxies, such as the rates of board turnover or management turnover, the level of discretionary spending or free cash flow, or the likelihood of takeover bids and acquisition. All proxies have their flaws, and methodology remains an issue and concern. At this time, we have more plausible stories than well-tested hypotheses.

Furthermore, critics of corporate governance systems and proposals argue that any system has costs that must be accounted for along with the expected benefits from the reduction of control rents and mismanagement. One widely alleged cost of the U.S. system is that market-based discipline creates an undesirable management orientation toward short-term stock price performance rather than long-term investment returns and growth. The argument rests on the proposition that the stock market is "myopic"—that, in pricing companies, it consistently overdiscounts longer-term expected cash flows and returns. There are various models of "asymmetric information" and accounts of short-term speculative bubbles that attempt to give more "structure" to this argument. Nevertheless, actual empirical evidence of consistent discount myopia in the stock market is weak;[11] and, even if it were persuasive, it would raise questions going far beyond matters of corporate governance.

Another criticism of corporate governance as analyzed here is that it should not be judged in terms of economic efficiency, the cost of capital, and shareholder wealth, but should take into account effects on other "constituencies" such as employees, suppliers, customers, managers, and the community at large.[12] All are characterized as "stakeholders," and the corporate governance system is to be judged by how well all interests are served. A focus on shareholders, it is argued, does not take into account costs imposed on these other stakeholders. What is invariably omitted from the argument, however, is consideration of the extent to which these other interests can protect themselves by contract. Moreover, many of these stakeholders can not really be said to make firm-specific investments that are subject to expro-

9. Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton: University Press, 1994).

10. See Andrei Shleifer and Robert Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52 (1997), pp. 737-83.

11. See Jeffrey Abarbanell and Victor Bernard, "Is the U.S. Stock Market Myopic?," working paper, Michigan Business School, 1995.

12. See Oliver Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985), Chapter 12.

In the less-developed countries and emerging market economies, the typical pattern is one of companies closely held or dominated by a founder, his family, and associates. The role of external equity finance is small; the business is financed by retained earnings and heavily by debt (often on a subsidized basis from government-controlled banks).

priation by management. Thus, we are returned to a point with which we began: what is unique about stockholder claims is the fact that they are long-term, residual, and necessarily poorly defined.

EVALUATING DIFFERENT CORPORATE GOVERNANCE SYSTEMS

But perhaps we do not need to be able to arrive at a logical and analytical answer to the question of which set of corporate governance rules is to be preferred. We can employ the test of economic survival—does not competition in the product market force evolution toward the most efficient governance structure? We have noted one qualification of that argument; political forces can impose fundamental constraints on the available economic choices. That makes it hard to assert that the U.S. or German or Japanese system would be best for others. Still, each of those systems has worked well enough to sustain capital accumulation, investment, and economic growth in a leading economy. By looking at their common elements, rather than their differences, we may be able to draw some tentative conclusions.

First, what can we say about their legal institutions? I do not feel altogether comfortable in going beyond the United States, but can at least offer some impressions. To begin, a distinction should be made between legal rules that define and protect shareholder voting rights and their ability to assert control, and legal rules that substitute for (or supplement) shareholder control by imposing enforceable duties on managers. There is a fairly well-developed set of laws establishing voting and control rights for shareholders in each country, although it is not difficult to suggest improvements. This would seem to be a minimum requirement for any effective corporate governance system, but it is lacking in some countries.

The importance of fiduciary duties, or their equivalent, has been less studied. One can postulate a continuum of situations involving conflicts of interest between managers and owners, with the conflict becoming less sharp (and perhaps the legal rules less essential). At one extreme would be outright theft, embezzlement, and misappropriation; without effective legal sanctions in these cases, only the gullible would part with their money. A somewhat less transparent form of achieving the same end is the self-dealing transaction between the manager and his firm. By buying too low or selling too high, the controlling party transfers wealth from the firm to himself, but the picture can be confused by intricate transactions in non-standard assets or subject to varying degrees of price unfairness. Enforcement becomes more difficult, but still seems essential if agency costs are to have any bound. The appropriation of corporate opportunities, excessive compensation, and consumption of managerial perks can be still more judgmental, and probably the legal rules are less effective, but the order of magnitude is also less. And when one reaches conflicts highly intertwined with the regular operation of the business, such as excessive diversification or self-retention by less competent managers, the fiduciary duty of loyalty (or the Japanese duty of supervision) probably offers little protection.

The United States has, it is my impression, gone considerably farther along this continuum than Japan or Germany. How effectively is hard to measure; the subject has not received much attention.[13] But it cannot simply be ignored by any corporate governance system intended to sustain external finance, particularly for companies in which there is a controlling majority shareholder or group. They may still be constrained to some extent by considerations of reputation, or the need for repeated dealings, but that is a constraint that disappears whenever the controlling party chooses to be free of it.

Second, all three systems have found methods for combining economic and control rights into large blocks, in order to overcome the ineffectualness of fragmented voting power. In Germany it takes the form of large investors, with their voting clout sometimes augmented by proxy control. In Japan, it takes the form of coordinated networks, acting through institutions like the presidents' council and the main bank. Both of those arrangements are relatively stable, whereas in the U.S. the aggregation is often ad hoc; voting power is assembled for the occasion, through a proxy contest or tender offer or leveraged buyout. The techniques differ, but they appear to be addressing a common need in an effective corporate governance system. Of course,

13. Notable very recent exceptions are Shleifer and Vishny (1997), cited in footnote 10; and Rafael LaPorta, Florencio Lopez-de-Silane, Andrei Shleifer, and Robert Vishny, "Legal Determinants of External Finance," working paper no.5879 (Cambridge: National Bureau of Economic Research, 1997).

where the arrangement is stable, it can be turned against outside minority stockholders.

In the last analysis, for many reasons we probably cannot point to an individual system as the best under all circumstances. There is some basis for identifying shortcomings or proposing improvements, but a number of quite distinctive institution arrangements seem to work at least passably and perhaps equivalently well.[14] That suggests a strategy of not adopting or entrenching any single system, but creating, if possible, the opportunity for any of them to take root and demonstrate superiority, even if only in a special niche.[15]

For the U.S., that strategy would mean removing the legal impediments to financial institutions accumulating more significant blocks, and to blockholders working together to monitor and, if necessary, to replace management. For Germany, it would mean encouraging the deepening of the securities market and the capacity of stockholders to oust management (currently usually protected in office by five-year contracts). For Japan, it would mean accepting the role of hostile tender offers and other forms of capital market discipline.

Of course, in each country there are political barriers to such reforms, led by managements and sometimes unions, and so the reforms may not be attainable. But there are also those who would benefit from enhanced corporate governance, and this might be a sensible strategy for them to follow; the tactics that would have the best prospect of success depend upon local political institutions and forces.

REFORMING THE SOUTH KOREAN GOVERNANCE SYSTEM

In conclusion, how does all of this apply to Korea? In the discussion that follows, my account of the Korean corporate governance system, as well as proposals to reform it, draws heavily on recent work by Korean governance scholars—in particular, a 1996 study by Young Ki Lee.[16]

The "ideal type" for Korea seems to be the *chaebol*, best described as a conglomerate web of firms, linked by indirect cross-shareholdings and a common founding-chairman in the core companies. The founder and his family on average own about 10%, and through cross-holdings control another 30% to 40%, of the group member firms. In those companies that are listed, financial institutions own about 30% of the equity. This is a picture of the family-dominated firm, mentioned earlier as typical for emerging economies, in which control rents are likely to be high.

Professor Lee's 1996 study does not describe the extent to which the legal system attempts to limit those control rents, beyond noting that board members do not represent outside shareholders, who are said to be "overlooked." The role of auditors is described as "atrophied." In addition, a set of managerial prerogatives known as "management right" was protected until 1997 by a prohibition of hostile tender offers, and custodians of public shares are prohibited from casting independent votes at the annual meeting (i.e., they "shadow vote").

The government has pursued a number of policies with the professed aim of "achieving wider shareholding." Listing on the first tier of the stock exchange now requires that over 40% of the company's stock be held by shareholders owning less than 1%, and that the principal owner and his family own not more than 51%. Cross-shareholdings by a firm may not exceed 25% of its net equity capital. A bank cannot without permission own over 10% of a company's shares, and no shareholder can own more than 4% of a bank. As can be seen, these rules work mainly to disperse outside shareholder voting power but do not threaten the continuance of dominance by the insider control group.

Professor Lee's study also reviews a number of proposals that have been made to improve Korean corporate governance. The suggested reforms have included strengthening the position of internal and outside auditors, allowing mergers and acquisitions approved by a panel, requiring more outside directors on boards, introducing the German supervisory board or two-tier system, and allowing banks to own greater equity shares in companies. Some of these same measures are promised in the government's request to the IMF for assistance.[17]

To aid in evaluating these and other reform proposals, there are a number of principles that we can derive, at least tentatively, from the body of experience that is available:

14. See Steven Kaplan, "Top Executives, Turnover, and Firm Performance in Germany," *Journal of Law, Economics, and Organization* 10 (1994), pp. 142-59; and Steven Kaplan, "Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States," *Journal of Political Economy* 102 (1994).

15. Roe (1994), cited in footnote 9.

16. See Young Ki Lee, "Corporate Governance in Korea: The Structure and Issues," working paper, Korea Development Institute, 1996; and see also Young Ki Lee and Young Jae Lim, "Corporate Governance in Korea: Issues and Prospects," working paper, Korea Development Institute, 1997.

17. International Monetary Fund Document, cited in note 2, Anx. III, p. 10, ¶30.

Charging management or the board with a legal mandate to "balance" the interests of various constituencies or stakeholders is merely to diminish any legally enforceable responsibility to shareholders, without creating a definable obligation to anyone else.

(1) Attention should be paid to the state of legal protection from transactions involving potential conflicts of interest. Governance in the narrow sense—the exercise of voting rights—is of little immediate help to minority shareholders confronting a controlling block. This is particularly significant if one is concerned with start-up technology firms in the Silicon Valley mode; venture capital firms are medium-term investors who need an exit for their investments in the form of an active IPO market.

(2) It is not enough to note that someone—a house bank, or main bank, or outside directors, or supervisory board—possesses the power to be an effective monitor of management. One must also examine closely their incentives to so act, and observe their performance in actual practice. Where direct incentives are mixed or weak, as in all of the above cases, it may be a mistake to have high expectations. There is no real substitute for the possession or acquisition by the outsiders of a major economic stake in the firm's success.

(3) Charging management or the board with a legal mandate to "balance" the interests of various constituencies or stakeholders is merely to diminish any legally enforceable responsibility to shareholders, without creating a definable obligation to any one else. In the United States, such statutes have been used by management primarily to enlarge their discretion to ignore shareholder preferences in hostile takeover situations. The result is to increase the scope of potential control rents and agency costs.

(4) Who pays for (such an increase in) agency costs? The existing owners of the firm, not new shareholders purchasing in the market—the price the new shareholders pay will reflect the reduction in their share of expected cash flows to the firm. This means that it is the owners of family firms, when they sell shares to the public at a higher price, who are the beneficiaries of effective legal rules and corporate governance. If better understood, this fact would facilitate the adoption of what are usually described as "shareholder" protections.

(5) The largest beneficiary of a more effective corporate system, however, is the nation as a whole, since the improvements in management performance and reductions in cost of capital in the economy aid it in domestic productivity and international competitiveness.

Applying these principles to the reforms being considered in South Korea suggests that the accomplishments will be modest. To begin, I am not aware of serious attention to the protection of minority shareholders from conflict-of-interest transactions, which have been commonplace in the chaebol structure. There is mention of enhanced disclosure, through consolidated balance sheets and enforcement of accounting standards in line with GAAP. But the legal rules to be applied to the disclosed transactions are a separate matter. Reliance on capital market discipline presupposes a capital market in which outside investors are willing to play a large role.

Further, capital market discipline also involves the possibility of outside investors being able to displace poorly performing management, even where it possesses a significant (though not controlling) ownership share. The only mechanism referred to in this regard is a liberalization of restrictions on mergers and acquisitions, along with the interesting promise that "bankruptcy provisions according to Korean law will be allowed to operate without government interference."[18] There is also a somewhat opaque statement that "[l]egislation concerning hostile takeovers will be submitted to the first special session of the National Assembly to harmonize Korean legislation on abuse of dominant positions in line with other industrial countries' standards."[19] It is doubtful that the chaebols' founding chairmen have much to fear.

One potentially important commitment by the government, however, is that it will discontinue directed lending and permit commercial banks to be run by their boards in the interest of their shareholders rather than the government.[20] That step, if taken, would be a rather drastic shift away from the Asian model.

18. International Monetary Fund Document, cited in footnote 2, Annex III, p. 45, ¶35.

19. Ibid., p. 44, ¶32.

20. Ibid., p. 45, ¶34.

■ KENNETH SCOTT

is Parsons Professor of Law and Business, Emeritus, Stanford Law School, and Senior Research Fellow, Hoover Institution.

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