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Addressing the Incentive for Expropriation Within Business Groups: The Case of the Korean Chaebol

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Christopher Hale

Abstract

This Article builds upon prior empirical findings on the prevalence of pyramids and focuses on the financing subsidies derived through the internal capital markets of pyramids–particularly through affiliations with financial institutions. Part I of this Article provides a brief overview of the relevant literature and the role that pyramids can play in separating ownership and voting rights. Part II describes the phenomenon by which the financing advantages derived by firms with financial affiliates, often non-bank financial institutions ("NBFIs"), results in a distortion of the market that contributes to pyramid expansion, thereby exacerbating the risk of minority shareholder expropriation. Part III then proposes a regulatory structure that could help reduce this distortion, drawing upon a recent EU Directive on supplementary supervision of financial conglomerates. Part IV uses the example of Korea to specifically describe how the subsidization provided by NBFIs within business groups can distort the market and lead to expropriation. Finally, Part V explains how the proposed regulatory structure could be concretely applied in Korea to address this distortion.

ARTICLES

ADDRESSING THE INCENTIVE FOR EXPROPRIATION WITHIN BUSINESS GROUPS: THE CASE OF THE KOREAN *CHAEBOL**

*Christopher Hale***

INTRODUCTION

In their highly influential empirical study of corporate ownership patterns around the world, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer ("LLS") demonstrated that the most commonly observed ownership structure worldwide is not the classic Berle and Means model of widely dispersed ownership, but that of a controlling shareholder which simultaneously manages the firm and exercises control in excess of its cash flow rights.[1] They also discovered that the pyramid ownership structure is the single most commonly used mechanism for allowing controlling shareholders to achieve voting rights in excess of their ownership rights.[2] Their study confirmed that the separation of ownership and control in concentrated ownership structures results in tension between controlling and minority shareholders (and not between managers and dispersed share-

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* The *chaebol* are Korean conglomerates. For further detail, see *infra* notes 96-122 and accompanying text. For convenience, this Article refers to the Republic of Korea (South Korea) as "Korea."

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1. *See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. Fin. 471, 472 (1999) [hereinafter *Corporate Ownership Around the World*] (finding that over one-fourth of the firms within the twenty-seven wealthy countries they studied were set up within pyramids and suggesting that the corresponding figure for firms worldwide is likely higher since poor countries display more highly concentrated ownership than the wealthy economies in their sample); *id.* at 474 (stating that controlling shareholders in most large companies "have control rights in firms in excess of their cash flow rights, largely through the use of pyramids").

2. *See id.* at 474, 500 ("Through pyramids, more so than through high voting rights shares, controlling shareholders acquire power disproportionate to their cash flow rights."); *see also infra* notes 22-23 and accompanying text.

holders), and further underscored the corporate governance dangers resulting from controlling shareholders which are able to maintain voting control over firms even without substantial direct ownership.[3] In the words of LLS, such controlling shareholders "have the power to expropriate minority shareholders and an interest in so doing."[4]

Using the corporate environment of Korea as an example, this Article builds upon LLS's empirical findings on the prevalence of pyramids and focuses on the financing subsidies derived through the internal capital markets of pyramids—particularly through affiliations with financial institutions. It contends that eradicating the private benefits reaped through this subsidization would remove a powerful ingredient of pyramid expansion, and proposes a legal solution that borrows from a recent European Union ("EU") Directive regulating financial conglomerates.

Part I of this Article provides a brief overview of the relevant literature and the role that pyramids can play in separating ownership and voting rights. Part II describes the phenomenon by which the financing advantages derived by firms with financial affiliates, often non-bank financial institutions ("NBFIs"),[5] results in a distortion of the market that contributes to pyramid

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3. *See Corporate Ownership Around the World*, *supra* note 1, at 511.

4. *See id.* As a policy suggestion for reducing this expropriation, La Porta, Lopez-de-Silanes, and Shleifer ("LLS") echoed the conclusions of an earlier empirical study they co-authored with Robert Vishny. *See id.* (citing Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. Fin 1131 (1997)). That is, LLS argued that because controlling shareholders unchecked by legal rules have a greater ability to expropriate minority shareholders, better investor protection would lead to greater investor confidence and thus result in a greater incidence of firms with widely diffused ownership structures. Their conclusion has spawned a debate in academic journals which this Article does not attempt to join. *See, e.g.*, John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151 (2001) (arguing that the correlation between strong capital markets and certain legal protections is partly explained by social norms); Amir N. Licht et al., *Culture, Law, and Finance: Cultural Dimension of Corporate Governance Laws* (May 2001) (unpublished manuscript), http://ssrn.com/abstract=267190 (last visited Oct. 1, 2006) (arguing that differences in cultural values help explain the correlation); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002) (arguing that strong corporate governance laws do little to protect minority shareholders against poor managerial decision-making, and thus concentrated ownership persists in countries with strong investor protection because, if control were fully separated from ownership, agency costs resulting from mismanagement (in the form of lower share value) would be too high, and because concentrated ownership already reduces agency costs of poor decision-making to an acceptable level).

5. In this paper, the term "non-bank financial institutions" ("NBFIs") is meant to

expansion, thereby exacerbating the risk of minority shareholder expropriation. Part III then proposes a regulatory structure that could help reduce this distortion, drawing upon a recent EU Directive on supplementary supervision of financial conglomerates. Part IV uses the example of Korea to specifically describe how the subsidization provided by NBFIs within business groups can distort the market and lead to expropriation, and Part V explains how the proposed regulatory structure could be concretely applied in Korea to address this distortion. Part VI concludes.

I. *PYRAMIDAL OWNERSHIP STRUCTURES AND THEIR CORPORATE GOVERNANCE IMPLICATIONS*

A. *Theories of Expropriation*

A large body of literature has pointed out that concentrated ownership often *improves* corporate governance when certain key conditions are met[6]—the most important of which being the controlling shareholder's exercise of voting rights in parallel with cash-flow rights.[7] Furthermore, it is recognized that a move toward more diffused ownership often *exacerbates* agency problems, since it often results simply in a controlling shareholder maintaining control with even fewer cash-flow rights.[8] Path dependence theorists like Lucian Arye Bebchuck and Mark

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include insurance companies and merchant banks, as well as investment trusts and securities companies.

6. *See generally* Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985); Clifford G. Holderness & Dennis P. Sheehan, *The Role of Majority Shareholders in Publicly Held Companies*, 20 J. FIN ECON. 317 (1988); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

7. *See, e.g.*, William W. Bratton & Joseph McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213 (1999) (citing Philippe Aghion & Patrick Bolton, *The Financial Structure of the Firm and the Problem of Control*, 33 EUR. ECON. REV. 286 (1989)); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002). While the term "corporate governance" can be associated with both the internal control apparatuses (i.e. the ability of minority investors and independent directors to check management decision-making), this Article focuses on the ability of certain business structures to avoid market disciplines—particularly, their ability to gain a financing advantage over competitors.

8. *See, e.g.*, Stijin Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholders*, 57 J. FIN. 2741, 2769-70 (2002); Mara Faccio et al., *Dividends and Expropriation*, 91 AM. ECON. REV. 54 *passim* (2001); Jensen & Meckling, *supra* note 6, at 312-30; Todd Mitton, *A Cross-firm Analysis of the Impact of Corporate Governance on the East Asian Financial Crisis*, 64 J. FIN. ECON. 215, 217-19 (2002).

J. Roe have pointed out that the success of the diffused ownership model in the United States hardly crowns it as the beacon for the world to follow,[9] and Ronald J. Gilson highlights the corporate governance virtues of concentrated ownership structures.[10] While empirical studies suggest that strong investor protection can help promote robust capital markets[11] and that weak investor protection generally leads to concentrated ownership,[12] neither of these findings suggest that concentrated ownership structures necessarily lead to poor corporate governance. The sky has not fallen in countries like Germany, for example, where the largest business groups are often controlled by families. Nor do companies in the United States with large block-holders trade at a discount to firms with diffused ownership.[13]

Rather, the main problem observed in concentrated ownership structures is that, when investor protection is low, the agency benefits derived from concentrated ownership are often outweighed by the private benefits of control reaped by the controllers.[14] Controlling shareholders often try to entrench themselves and extract further private benefits from minority investors through a process known as "rent protection," and they have a host of incentives and tools to keep control over their enterprises even as their cash-flow rights decrease.[15] Such private ben-

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9. *See generally* Lucian Arye Bebchuck & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (arguing that the identity of the most efficient type of ownership structure for businesses in a given country might depend on earlier ownership patterns). For more information on "path dependence" theory, see Paul A. David, *Path Dependence, Its Critics, and the Quest for "Historical Economics," in* EVOLUTION AND PATH DEPENDENCE IN ECONOMIC IDEAS: PAST AND PRESENT 15 (Pierre Garrouste & Stavros Ioannides eds., 2001).

10. *See generally* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001).

11. *See, e.g.*, La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

12. *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 571-89 (2004).

13. *See* Clifford G. Holderness & Dennis P. Sheehan, *Constraints on Large-Block Shareholders*, *in* CONCENTRATED CORPORATE OWNERSHIP 139, 162-64 (Randall K. Morck ed., 2000). Mark Roe argues that this phenomenon likely results from the preference of public shareholders for controlling block-holders when the benefits from reduced managerial agency costs exceed the private benefits reaped by the controlling shareholder. *See* Roe, *supra* note 4, at 239-40.

14. *See* Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22 (2000).

15. *See, e.g.*, Lucian Ayre Bebchuck, *A Rent-Protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), http://www.nber.org/papers/w7203 (last visited Oct. 1, 2006).

efits of control are generally larger—and thus more minority shareholders are expropriated—in countries where concentrated ownership structures are widespread and investor protection is weak.[16] Further, the fact that many business groups are both managed and controlled by families manifests even greater agency problems in such countries because families have a uniquely deep-seated interest in retaining control.[17]

In that light, it is evident that the incentives for such expropriation result less from concentrated ownership itself than from the size of the gap between ownership and voting rights and the prevailing legal environment.[18] That is, if the controlling shareholder directly owns the majority of cash-flow rights in a firm, this shareholder is much less likely to transfer resources out of this firm—or "expropriate"—than a controlling shareholder who owns only a small percentage of the firm's cash-flow rights yet exercises control through measures such as a pyramid structure or cross-shareholding.[19] Admittedly, the simple assertion that greater separation between ownership and voting rights

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16. *See, e.g.*, Claessens et al., *supra* note 8, at 2269-70; Dyck & Zingales, *supra* note 12, at 540-41; Faccio et al., *supra* note 8, at 59.

17. *See* Mike Burkart et al., *Family Firms*, 58 J. FIN. 2167, 2168 (2003) (citing Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J POL. ECON. 1155 (1985)). Claessens et al. observed family business groups as the worst exploiters of the gap between ownership and voting rights when investor protection is low. *See* Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 101, 109 (2000); *see also* Ronald C. Anderson & David M. Reeb, *Founding Family Ownership, Corporate Diversification, and Firm Leverage*, 46 J. L. & ECON. 653 (2003). Because pyramids are often large, the hereditary entrenchment of only a few families can often affect hundreds of firms, and Morck et al. and Bianchi et al. have specifically observed this phenomenon in Canada and Italy, respectively. *See* Randall K. Morck et al., *Inherited Wealth, Corporate Control, and Economic Growth*, *in* CONCENTRATED CORPORATE OWNERSHIP, *supra* note 13, at 319, 332; Marcello Bianchi et al., *Pyramidal Groups and the Separation of Ownership and Control in Italy*, *in* THE CONTROL OF CORPORATE EUROPE 154, 180 (Fabrizio Barca & Marco Becht eds., 2001).

18. Jensen and Meckling recognized this phenomenon over three decades ago, and empirical studies have confirmed their prescient theory. *See* Jensen & Meckling, *supra* note 6. *See generally* Faccio et al., *supra* note 8 (finding that the tendency of controlling shareholders to expropriate minority shareholder wealth increases as their control exceeds their ownership rights); Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis?* (July 21, 2000) (unpublished manuscript), http://ssrn.com/abstract=237809 (last visited Oct. 1, 2006)) (finding that variables related to the legal environment, rather than the ownership concentration variable, better explain the variation in the value of control benefits).

19. *See* Bebchuck, *supra* note 15, at 28-29. The same rings true for family-controlled firms, notwithstanding their general stubbornness in maintaining control. *See* Anderson & Reeb, *supra* note 17, at 653-56.

leads to greater risk of expropriation risks over simplification because other factors also make a difference, such as the fluidity of the takeover market, the robustness of outside monitoring, and the extent to which controlling families value their reputation in a given society.[20] As will be argued below, however, the ability of controlling shareholders to exercise control rights in excess of their voting rights is the most powerful incentive for expropriation,[21] and reducing this incentive should be the first task at hand.

B. *The Structure of Pyramids: Weighing Efficiency Advances Against Expropriation Concerns*

Pyramids are generally comprised of a controlling shareholder (often a family that also plays a management role) at the top of the business group, which often lacks significant cash-flow stakes in all the firms within the pyramid but is able to exercise control over the entire pyramid through the votes of intermediaries.[22] That is, the family directly controls a firm, which in turn controls another firm, which in turn controls another firm, and at least some of these firms are partially owned by outside shareholders. In this way, the family is able to access the cash flow rights of the entire pyramid, including those ostensibly belonging to minority shareholders, even as it shares ownership with these shareholders.[23]

From a corporate governance standpoint, a key difference between pyramid ownership structures and diffused ownership or bank-centered models is the following: pyramid ownership structures, in which the controlling shareholders generally function as managers, are generally structured to exclude built-in monitoring agents save for the voices of oft-disenfranchised mi-

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20. *Compare* Bianchi et al., *supra* note 17, at 180, *with* Jonas Agnblad et al., *Ownership and Control in Sweden: Strong Owners, Weak Minorities, and Social Control, in* THE CONTROL OF CORPORATE EUROPE, supra note 17, at 228, 228.

21. *See, e.g.*, Faccio et al., *supra* note 8, at 57-59.

22. *See, e.g.*, Lucian Arye Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights, in* CONCENTRATED CORPORATE OWNERSHIP, *supra* note 13, at 295, 298-99. The subject of pyramid group structures should not be confused with that of so-called pyramid (or Ponzi) schemes, which this Article does not address.

23. *See id.* at 298-99.

nority shareholders farther down the pyramid.[24] In bank-centered ownership structures the bank itself fulfills monitoring functions,[25] and reputational intermediaries such as accounting firms play the monitoring role in firms where ownership is widely dispersed through strong capital markets. In contrast, the family at the top of the pyramid is just that—at the *top* of the ownership structure—and its control of the votes over the entire pyramid greatly diminishes the ability of endogenous agents such as minority shareholders to counteract the family's ability to expropriate minority shareholder value.[26]

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24. *See* SEA-JIN CHANG, FINANCIAL CRISIS AND TRANSFORMATION OF KOREAN BUSINESS GROUPS: THE RISE AND FALL OF CHAEBOLS 174 (2003).

25. A voluminous debate has occurred on whether the bank-centered model or the U.S. model provides better monitoring of management, and the relative advantages and disadvantages of each have long been pointed out. Still, there is general agreement that banks do perform at least some beneficial monitoring functions, as do transactional cost intermediaries in the U.S. system. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitors*, 91 COLUM. L. REV. 1277 (1991); Ronald Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991). In the Japanese context, there are a few outliers who put forth the radical suggestion that keiretsu banks (Japanese bank-centered business conglomerate) do not perform a monitoring function, and rather, that keiretsu themselves do not even exist and are Marxist figments of the imagination. *See* Yoshiro Miwa & J. Mark Ramseyer, *The Fable of the Keirestu, and Other Tales of Japan We Wish Were True* (John M. Olin Ctr., Harv. Univ., Discussion Paper No. 316, 2001), http://ssrn.com/abstract=263979 (last visited Oct. 1, 2006). Needless to say, their view is in the minority. *See* Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 LAW & SOC. INQUIRY 425 (2002) (explaining the majority view, attributed to the influential theories of Masahiko Aoki, that keiretsu banks have played a crucial monitoring role).

26. At first glance, the prevalence of pyramid structures around the world may be somewhat surprising, since other mechanisms exist that allow a family to retain control over an entire business group with minimal cash-flow rights. Particularly, dual-class stock seems to be a simpler method of raising external finance through equity while retaining voting control. Yet, even in those countries where the issuance of dual-class equity is legal, families often do not fully take advantage of this seemingly simple mechanism. The best explanation for this puzzling fact is likely that in countries with low investor protection, non-voting shares generally incur large discounts from the price of voting shares, and this discount discourages their use as financing tools. After all, in countries where minority investors are not well protected, such investors have few means other than voting to ensure that their interests are well-served. *See* Nenova, *supra* note 18 (finding large discounts on dual class shares in countries with low investor protection). Other methods of separating control from cash-flow rights are that of circular and cross-shareholding, but they are not generally used by controlling shareholders as the main strategy in guaranteeing control over a business group. Not only are cross-shareholding structures illegal in many countries, but both cross-shareholding or circular shareholding structures, when used alone, generally place mutual control into the hands of all of the group's members, rather than the hands of a single controlling

Another perceived benefit of pyramidal ownership structures is their efficiency. Building upon Ronald Coase's famous observation that firms serve to economize on transaction costs,[27] Oliver E. Williamson was among the first to conduct a serious study of conglomerates, and his work on the "M-form structure" is widely cited for the proposition that transaction costs among divisions of a conglomerate can be reduced through internal resource allocation.[28] A great deal of subsequent literature has highlighted the efficiencies of internal resource allocation among a conglomerate's diversified firms.[29] In particular, Raghuram G. Rajan and Luigi Zingales, as well as Tarun Khanna and Krishna Palepu, contend that business groups can play valuable resource-allocation roles that nascent markets are unable to fulfill in early stages of economic development.[30] These benefits, however, tend to dissipate as the economy develops and external sources of capital become more easily accessible,[31] or may

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shareholder. Since no single entity holds absolute control over all the others, and since all of the group's members are dependent on each other, such structures tend to survive only in societies with unusually high levels of mutual trust (e.g. Japan). Thus, the much more common function of circular and cross-shareholding is to enhance an already existing pyramid structure, since such a structure channels control and cash flow into a single locus of power at the top of the pyramid. *See Corporate Ownership Around the World*, *supra* note 1, at 498-501.

27. *See* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390-92 (1937).

28. "M-form structure" is the terminology used for multidivisional conglomerates. *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 128 (1975); Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537, 1557-60 (1981) [hereinafter *The Modern Corporation: Origins, Evolution, Attributes*]. A similar theory on the efficiency of internal capital markets in conglomerates is also attributed to Armen Alchian, whose writings predated that of Williamson. *See* Armen Alchian, *Corporate Management and Property Rights*, *in* ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 348, 348-49 (Henry Manne ed., 1969).

29. *See* Nathaniel H. Leff, *Industrial Organization and Entrepreneurship in Developing Countries: The Economic Groups*, 4 ECON. DEV. & CULTURAL CHANGE 661, 670-72 (1978); *see also* Robert H. Gertner et al., *Internal Versus External Capital Markets*, 109 Q. J. ECON 1211, 1212, 1223-25 (1994); Hyun-Han Shin & Rene M. Stultz, *Are Internal Capital Markets Efficient?*, 113 Q. J. ECON. 531, 533 (1998); Jeremy C. Stein, *Internal Capital Markets and the Competition for Corporation Resources*, 52 J. FIN. 111, 116-18 (1997); Rene M. Stultz, *Managerial Discretion and Optimal Financing Policies*, 26 J. FIN. ECON. 3, 4 (1990).

30. *See* Tarun Khanna & Krishna Palepu, *Is Group Affiliation Profitable in Emerging Markets?: An Analysis of Diversified Indian Business Groups*, 55 J. FIN. 867, 868-69 (2000); Raghuram G. Rajan & Luigi Zingales, *Which Capitalism? Lessons from the East Asian Crisis*, 11 J. APPLIED FIN. 40, 44-46 (1998).

31. *See* Khanna & Palepu, *supra* note 30, at 888; *see, e.g.*, Rajan & Zingales, *supra* note 30, at 46-47.

disappear altogether in times of financial crisis.[32]

On the other side of the coin, a number of theorists have questioned the efficiency of resource allocation in conglomerates. Michael C. Jensen's "free cash flow" theory posits that conglomerate managers with too much money tend to invest it inefficiently, thus exacerbating the agency problem.[33] Numerous economists have highlighted the rent-seeking behavior of conglomerate managers with various empirical studies.[34] Simon Johnson et al. coined the term "tunneling" to explain the phenomenon by which controlling shareholders have strong incentives to channel profits across firms to those in which they have higher cash flow rights, whether through outright theft or less obvious means.[35]

Furthermore, most observers who address the agency problems associated with pyramids in particular argue that the ability of controlling shareholders to exercise control with comparatively little ownership results in a huge incentive to expropriate. Luigi Zingales, in his oft-cited study of Italian pyramidal business groups, found evidence of the phenomenon in his study of the Milan Stock Exchange.[36] Stijn Claessens et al. and Mara Faccio et al. observed tunneling among East Asian pyramids,[37] while Marianne Bertrand et al. found it in India.[38] All in all, perhaps Lucian Arye Bebchuck et al. summarized it best in their observation that when "the size of cash-flow rights held decreases, the size of agency costs increases, not linearly, but rather at a sharply increasing rate."[39]

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32. *See, e.g.*, Johnson et al., *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141, 142 (2000); Mitton, *supra* note 8, at 216.

33. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323-24 (1986).

34. *See* Claessens et al., *supra* note 17, at 99-104; Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 46 (1990); *see also* David S. Scharfstein & Jeremy C. Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-seeking and Inefficient Investment*, 55 J. FIN. 2537 (2000).

35. Johnson et al., *supra* note 14, at 22-23.

36. *See generally* Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUDIES 125 (1994); *see also* Bianchi et al., *supra* note 17, at 154-56.

37. *See* Stijn Claessens et al., *Expropriation of Minority Shareholders: Evidence from East Asia* (Pol'y Res. Dissemination Ctr., Working Paper No. 2088, 1999); Faccio et al., *supra* note 8, at 54-55.

38. *See* Marianne Bertrand, et al., *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 Q. J. ECON. 121, 121-22 (2002).

39. *See* Bebchuck, *supra* note 22, at 296.

II. *THE FINANCING ROLE OF PYRAMIDAL BUSINESS GROUPS*

A. *Determinants of Pyramid Expansion*

In light of the findings above, one might be tempted to conclude that the sole purpose of pyramids is to facilitate the ownership and voting rights gap and the expropriation of shareholders. However, it is not always the case that pyramids are utilized to allow controlling shareholders to exercise control rights in firms significantly above their cash flow rights. For example, it has been pointed out that pyramids in countries such as Germany, Chile, and Turkey are often controlled by families whose voting and cash flow stakes in each of the pyramid's firms are nearly parallel,[40] and thus the same level of control could have been achieved even without the use of a pyramid structure. In some pyramids, the controlling shareholder would own at least a fifty-one percent equity stake of all the subsidiaries in the pyramid even without the aid of a pyramid structure,[41] and these indications tend to contradict the idea that the *raison d'etre* of the pyramid structure is simply to enhance the controlling shareholder's level of control over the pyramid.

Further negating this theory, even in those countries where the average gap between the cash flow and voting rights of controlling shareholders is quite large, dual-class shares with differential voting rights are not used nearly as much as pyramid structures to achieve this separation even when the issuance of such shares is legal.[42] If controlling shareholders were simply interested in keeping control while reaping financial benefits, they would issue non-voting shares at or near the level allowed by law to raise the maximal amount of capital possible while retaining control, regardless of whether the price of these shares were dis-

40. *See* Heitor Almeida & Daniel Wolfenzon, *A Theory of Pyramidal Ownership and Family Business Groups*, 61 J. FIN. (forthcoming Dec. 2006) (manuscript at 30-31) [hereinafter *A Theory of Pyramidal Ownership*], http://ssrn.com/abstract=721801) (last visited Oct. 3, 2006).

41. *See id.* at 24. These types of pyramids are quite benign from a corporate governance standpoint and are therefore not the focus of this Article, though it should be noted that even in these cases, the controlling shareholder retains the convenient ability to effect such a separation if a sudden or unexpected need for a large amount of external equity financing were to arise. *See id.* at 41. Rather, the point here is to note that the expansion of pyramids is promoted more by the internal capital markets of pyramids, rather than conspiracies to expropriate.

42. *See id.* at 2; *see also Corporate Ownership Around the World*, *supra* note 1, at 500.

counted.[43] Finally, there are examples of pyramids—such as those in Sweden—that do effect a significant ownership and voting rights gap, but expropriation generally does not occur.[44]

In light of these observations, it becomes apparent that the view of pyramidal ownership structures as mere instruments of control and expropriation cannot be entirely correct. In a recent study along these lines, Heitor Almeida and Daniel Wolfenzon developed a robust model of pyramids that helps explain why pyramids exist even when the separation of ownership and voting rights is minor and other tools exist to effect this separation.[45] They found that the most accurate predictor of the prevalence of pyramids in a given country is the extent of the difference between the terms at which the controlling shareholder of a business group can access internal and external finance, which is generally related to the level of investor protection.[46] That is, when investor protection is low and business groups with large internal resources enjoy a financing advantage

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43. *See A Theory of Pyramidal Ownership*, *supra* note 40, at 2-3. As previously mentioned, one explanation for this apparent irony could be the fact that the discount incurred on nonvoting shares in countries with low investor protection—where the ability to exercise voting rights becomes all the more important to minority shareholders with few alternative rights—discourages their use as financing tools. But the existence of such a discount would still not validate the traditional view that controlling shareholders who use pyramids are necessarily consumed with finding ways to separate ownership and voting rights, it should be noted that pyramid structures are common even in those countries where the discount on non-voting shares is, on average, quite small. *See id.* at 3. For example, Tatiana Nenova found small discounts on dual-class shares in Canada and Sweden, two countries where pyramids abound. *See* Nenova, *supra* note 18, at 32; *see also* Agnblad et al., *supra* note 20, at 228-58; Morck et al., *supra* note 17, at 332.

44. *See* Agnblad et al., *supra* note 20, at 251-52. Swedish pyramids reportedly allow the controlling shareholder (often the Wallenberg family) to exercise an average of ten percent more votes in the pyramid than its cash-flow rights would normally allow—yet expropriation is generally unheard of. *See id.* at 229, 235-38. Swedish economists explain this anomaly by pointing to factors such as the extraordinary importance that Swedish business families place on their reputation as social do-gooders, but an equally plausible explanation stems from the extremely unusual characteristics of the Swedish financial market. That is, capital markets are deep and well-developed even though the level of investor protection is rather low. *See id.* at 251-53. Thus, controlling shareholders in Sweden have much less incentive to expropriate minority shareholders, since there already exists in Sweden a critical mass of investors who will trustingly part with their capital at reasonable terms. *See id.* at 229-30.

45. *See A Theory of Pyramidal Ownership*, *supra* note 40, at 1-2.

46. *See id.* at 3-4. Almeida and Wolfenzon also note that to a lesser extent, firms within industries that require high levels of investment or display low levels of profitability are more likely to be set up in pyramid. However, they note that the terms at which external finance can be financed is the most crucial element in the analysis, and this Article focuses on that point. *See id.* at 3-5.

over competitors relying on external markets, firms inside the pyramid are more likely to grow.[47] Furthermore, when investor protection is low, controlling shareholders have the incentive to utilize pyramid structures rather than horizontal ownership structures (even those employing dual-class votes or cross-shareholdings), because the former generally results in a higher payoff advantage than the latter, since the entire cache of retained earnings can be accessed with fewer cash-flow rights.[48] This advantage is generally larger in countries where ownership and voting rights can be more easily separated (again, due to low investor protection), and pyramids are thus likely to be more prevalent in such countries. Yet, even in circumstances where the gap between ownership and voting rights is minor, pyramids can still allow controlling shareholders to access the entire stock of internal capital with only partial cash-flow rights, and they can thus play a valuable role as an internal financing vehicle.[49]

Almeida and Wolfenzon's model builds in some ways upon Williamson's theory that business groups tend to form when resources can be amassed and allocated more efficiently through internal markets rather than external capital markets.[50] Yet, its main contribution to the literature is its ability to predict that when the terms of accessing external finance descend to the corresponding level for the internal financial markets of business groups (whether through stronger investor protections or otherwise), the size of existing pyramids will shrink. Consequently, fewer new firms will be formed inside pyramids because such firms would gradually lose their financing advantage over competing firms financed through the external market.[51] In this way, the model aids in understanding how differences in the terms of finance accessed by group-affiliated and non-group-affil-

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47. *See id.* at 4.

48. *See id.* at 3-4. Low investor protection (and thus easier access to capital internal to the pyramid) incentivizes using pyramid structures because it allows firms to access more funds at higher proportions than they would if they had to access capital on outside markets. *See id.* at 3.

49. *See id.* at 3-5. In this case, however, the pyramid would likely be smaller than it would have been if the gap between ownership and voting rights were larger, because then the family would have been able to exercise control over more firms.

50. *See The Modern Coporation: Origins, Evolution, Attributes, supra* note 28, at 1558.

51. *See id. passim*; *see also* Heitor Almeida & Daniel Wolfenzon, *Should Business Groups be Dismantled? The Equilibrium Costs of Efficient Internal Capital Markets*, 79 J. FIN. ECON. 99, 116-18 (2006).

iated firms contributes to the expansion of pyramids and the increased ownership and voting rights gap that results. The model can also help explain why tunneling is often used as an avenue of finance,[52] and why LLS found that pyramid structures are significantly more likely to occur in countries with low investor protection, where external capital would be more difficult to access.[53]

With this insight into the financing roles that pyramids play, it is evident that more attention should be given to the financing advantage reaped by controlling families through their control of financial institutions, which enables firms within pyramids with financial affiliates to access capital at more favorable terms than other firms. The ill effects of such cronyism have been empirically observed in economies such as Russia,[54] Mexico,[55] Thailand,[56] Hong Kong,[57] and Korea.[58] In Europe, it is reported that in twenty-eight percent of publicly-held companies the ultimate controlling shareholder also owns a commercial bank (while the corresponding figure for East Asia is sixty percent).[59] These figures would be even higher, of course, if NBFIs were included

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52. *See* Kee-Hong Bae et al., *Tunneling or Value Added? Evidence from Mergers by Korean Business Groups*, 52 J. FIN. 2695, 2696 (2002); Bertrand, et al., *supra* note 38, at 121-22; Bianchi et al., *supra* note 17, at 170; Claessens et al., *supra* note 37.

53. *See Corporate Ownership Around the World*, *supra* note 1, at 500 (stating that "fully 26 percent of firms [in the authors' sample] that have ultimate owners are controlled through pyramids. That fraction is 18 percent in countries with good shareholder protection, and 31 percent in countries with poor protection.").

54. *See, e.g.*, Luc Laeven, *Insider Lending and Bank Ownership: The Case of Russia*, 29 J. COMP. ECON. 207 (2001).

55. *See, e.g.*, Rafael La Porta et al., *Related Lending*, 118 Q. J. ECON. 231 (2003); Noel Maurer & Stephen Haber, *Related Lending and Economic Performance: Evidence from Mexico* (Dec. 8, 2004) (unpublished manuscript), http://ssrn.com/abstract=641824 (last visited Oct. 6, 2006)).

56. *See, e.g.*, Chutatong Charumilind et al., *Connecting Lending: Thailand Before the Financial Crisis* (Ctr. Econ. Inst., Working Paper No. 19, 2003); Piman Limpaphayom & Sirapat Polwitoon, *Bank Relationship and Firm Performance: Evidence from Thailand Before the Asian Financial Crisis*, 31 J. Bus. Fin. & Acct. 1577 (2004).

57. *See, e.g.*, Steven Yan-Leung Cheung, et al., *Tunneling, Propping and Expropriation: Evidence from Connected Party Transactions in Hong Kong* (unpublished manuscript), http://ssrn.com/abstract=573283 (last visited Oct. 6, 2006).

58. *See, e.g.*, Ming Ming Chiu & Sung Wook Joh, *Loans to Distressed Firms: Cronyism, Related Lending and Bank Governance* 2, 6 (Ctr. Econ. Inst., Working Paper No. 2, 2004), http://cei.ier.hit-u.ac.jp/news/paper/Sungwook%20Joh.pdf (last visited Oct. 29, 2006).

59. *See* La Porta et al., *supra* note 55, at 233.

in the count.[60]

These types of relationships can have a myriad of negative corporate governance implications. When a firm within the pyramid is publicly owned, the minority shareholders of that particular firm would not be well-served if a portion of the firm's retained earnings were directly used to increase the internal capital markets of the pyramid as a whole to the detriment of that firm, and would instead expect it to be either paid back to them in dividends or reinvested back into the firm. However, as this Article has pointed out, the sad reality is that in countries with low investor protection, minority shareholder capital is often expropriated to affiliate firms, thus contributing to the internal capital markets as a whole and further expansion of the pyramid.[61]

Generally, the main weapon against this type of expropriation is increased minority investor protections, consisting of, inter alia, streamlined requirements for bringing derivative suits and initiating proxy contests. However, greater investor protection mechanisms on their own fail to address one particularly lucrative source of improper financing benefits—that of other people's money placed in affiliated NBFIs, or even commercial banks in rarer instances. Frequently privately held, NBFIs generally consist of insurance companies, investment trusts, merchant banks, and securities companies. The often huge amounts of capital captured by these institutions are certainly not "retained earnings" to the extent that such earnings do not arise from their share of investment income. Rather, they are asset holdings on behalf of, inter alia, insurance policyholders in the case of insurance companies (or minority shareholders in the case of listed insurance companies), investors in the case of investment trusts and merchant banks, and depositors in the case of commercial banks. While the managers of these institutions certainly have the authority to invest these assets, they also have the fiduciary duty to invest them in ways they believe would bring the most value to the beneficiaries.[62] Because the investment activi-

60. *See* Mara Faccio et al., *Debt and Expropriation* 43 (July 1, 2003) (unpublished manuscript), http://ssrn.com/abstract=239724 (last visited Oct. 6, 2006)).

61. *See A Theory of Pyramidal Ownership*, *supra* note 40, at 3.

62. *See generally* Gerard Hertig, *Convergence of Substantive Law and Convergence of Enforcement: A Comparison*, *in* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 328 (Jeffrey N. Gordon & Mark J. Roe eds., 2004)

ties of such pyramid-affiliated financial institutions are often influenced by the controlling family, the assets of such institutions often wind up being invested in affiliates which do not pose sound investment opportunities, and in some cases survive chiefly because of their crony relationship with the institution.[63]

The most obvious way in which families reap private benefits through their control of financial institutions is by directing the financial institutions to extend finance at below-market terms to non-financial firms within the group, and this can be done in a virtually infinite number of ways.[64] This subsidization effect encourages the creation of new firms inside the pyramid, where they can reap the benefits of their association with finance affiliates, leading to an enlargement of the pyramid and the number of firms under the control of the family. It also enables firms within the pyramid to compete on unfair terms with firms that do not receive such financing help, and thus discourages the beneficial effects of competition.[65]

B. *Taking Action: The Example of the European Union's Directive 2002/87/EC*

How can the private benefits gained through intra-group transactions with financial affiliates be reduced? Various jurisdictions have chosen to deal with the problem in various ways and can serve as models to follow. The U.S. regulatory system is not a particularly helpful model because its extraordinarily deep securities markets and historically unique mix of federalism and populism have given Congress and the states the ability to place unusually severe restrictions on the investments of financial institutions.[66] Rather, the EU is a more apt model because the preva-

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63. For a particular example of this phenomenon, see the discussion of Daewoo, *infra* notes 116-22 and accompanying text, and the studies cited above about cronyism in Korea, Russia, Japan, *supra* notes 54-58 and accompanying text, for the proposition that controlling families use internal capital markets to direct capital toward unsound investments.

64. For specific examples of how such subsidization occurs in Korea, see *infra* notes 136-40 and accompanying text. For a journalistic report of the crony relationships between financial institutions and their affiliates in various East Asian business groups, see MICHAEL BACKMAN, ASIAN ECLIPSE: EXPOSING THE DARK SIDE OF BUSINESS IN ASIA 59-80 (rev. ed. 2001)

65. *See* Almeida & Wolfenzon, *supra* note 51, at 130-31.

66. *See generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994). For a summary of legislative and judicial responses in the United States to the 2001-2002 scandals involving Enron,

lence of family-controlled business groups in the region more accurately represents the corporate environment of the developing world. In December 2002, the European Parliament adopted Directive 2002/87/EC (the "Supplementary Supervision Directive" or the "Directive"), which called for supplementary supervision of financial conglomerates.[67] The Directive applies many of the recommendations of the Basle Committee on Banking Supervision,[68] and has since been implemented by the EU Member States and entered into force on January 1, 2005.[69] The relevant provisions are worth a brief discussion here.

The main objective of the Directive is to provide stronger regulation of entities within "financial conglomerates," which are defined as, inter alia, business groups headed by regulated entities (i.e., domestic financial institutions) whose activities in the insurance sector as well as the banking and investment services sectors are "significant."[70] Such activities are deemed "significant" if the assets of these sectors exceed ten percent of the group's assets based on average ratios of balance sheets and solvency requirements, or if the smallest financial sector has a balance sheet total of at least €6 billion.[71] These are not hard and fast requirements, however, and the relevant authorities are given the flexibility to bypass them if needed.[72]

Worldcom, Tyco, and others, see John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 336-42 (2004).

67. *See* Council Directive No. 2002/87, O.J. L 35/1 (2003) [hereinafter Supplementary Supervision Directive].

68. *See* Michael Gruson, *Consolidated and Supplementary Supervision of Financial Groups in the European Union (Teil II)*, DER KONZERN, Apr. 15, 2004, at 253-54; *see generally* Michael Gruson, *Supervision of Financial Holding Companies in Europe: The EU Directive on Supplementary Supervision of Financial Conglomerates*, 36 INT'L LAW. 1229 (2002) [hereinafter *Supervision of Financial Holding Companies*].

69. *See* Supplementary Supervision Directive, arts. 32, 33, O.J. L 35/1, at 22-23 (2003).

70. *See id.*, art. 2(4), 2(14)(d), 2(14)(e), O.J. L 35/1, at 3-4 (2003); *see also id.*, art. 2(14)(b), O.J. L 35/1, at 4 (2003). A streamlined description of the Directive will be provided here, and only the provisions relevant to intra-group transactions will be mentioned.

71. *See id.*, art. 3(2), O.J. L 35/1, at 5 (2003). Business groups that are not headed by regulated entities must meet the requirements of Article 3(1) to be deemed a financial conglomerate. That is, the ratio of the balance sheet total of the regulated and non-regulated financial sector entities in the group to the balance sheet total of the group as a whole must exceed forty percent. *See id.*, art. 3(1), 3(3), O.J. L 35/1, at 5 (2003).

72. *See id.*, art. 5(4), O.J. L 35/1, at 7 (2003). The first sub-paragraph gives the relevant authorities the flexibility to regulate entities within conglomerates that do not

Once it is determined that a regulated entity is part of a financial conglomerate, the intra-group transactions made by that regulated entity are subject to supervision by competent authorities,[73] and such supervision includes ensuring the fairness of the transactions.[74] "Intra-group transactions" are liberally defined as "all transactions by which regulated entities within . . . financial conglomerate[s] rely either directly or indirectly upon other undertakings within the same group or upon any natural or legal person linked to the undertakings within that group by 'close links,' for the fulfilment of an obligation, whether or not contractual, and whether or not for payment."[75] The Directive requires that the regulated entities file regular reports, at least annually, of all significant intra-group transactions, and it leaves it to the Member States' regulators to define "significant."[76] It similarly encourages the Member States to set up their own "quantitative limits and qualitative requirements," or to take other measures that would achieve the objective of the Directive in regard to intra-group transactions of regulated entities within a financial conglomerate.[77]

Finally, the Directive includes strong enforcement measures. Article 17 requires Member States to give their regulators "the power to take any supervisory measure deemed necessary in order to avoid or to deal with the circumvention of sectoral rules

meet the requirements for being deemed a "financial conglomerate." In this case, the authorities must then "determine whether and to what extent supplementary supervision of the regulated entities is to be carried out, as if they constitute a financial conglomerate." *See id.*

73. *See id.*, art. 5(1), O.J. L 35/1, at 6 (2003).

74. In his article on the European Union ("EU") Directive, Michael Gruson cites the Basle Committee on Banking Supervision to explain the intention behind the supervision and regulation of intra-group transactions among financial conglomerates: "Intra-group transactions may cause supervisory concerns when they: (i) result in capital or income being inappropriately transferred from the regulated entity; (ii) are on terms or under circumstances which parties operating at arm's-length would not allow and may be disadvantageous to a regulated entity; (iii) can adversely affect the solvency, the liquidity, and the profitability of individual entities within a group; or (iv) are used as a means of supervisory arbitrage, thereby evading capital or other regulatory requirements altogether." *Supervision of Financial Holding Companies*, *supra* note 68, at 1249.

75. *See* Supplementary Supervision Directive, art. 2(18), O.J. L 35/1, at 5 (2003). Article 2(13) defines "close links" as either direct or indirect ownership of at least twenty percent of the voting rights or capital of an undertaking or a relationship analogous to a parent-subsidiary relationship. *See id.*, art. 2(13), O.J. L 35/1, at 4 (2003).

76. *See id.*, Annex II, O.J. L 35/1, at 27 (2003).

77. *See id.*, art. 8(3), O.J. L 35/1, at 8 (2003).

by regulated entities in a financial conglomerate," and Article 16 calls upon regulators to take "necessary measures . . . to rectify the situation as soon as possible" when inter-group transactions threaten the regulated entities' financial position.[78]

All in all, the structure of supervision called for in the Directive is reminiscent of Germany's style of cross-sectoral financial supervision by a central authority. In 2002, Germany established its Federal Financial Supervisory Authority, the duties of which include enforcing the supervisory requirements of Germany's Banking Act and Insurance Business Act.[79] The Directive can also be compared somewhat to Sections 23A and 23B of the Federal Reserve Act in the United States, which require a fairness review of transactions between federally insured deposit banks and their affiliates.[80] The EU Directive's scope of supervision, however, covers much more than transactions involving government-insured banks.[81]

In that light, it is instructive to note the methods employed by the European Parliament. The Parliament apparently did not put much trust in the extant fiduciary duties of independent directors or asset managers of financial institutions to judge the fairness of transactions. Cynics (or perhaps realists) might say that this should not come as much of a surprise, given that the independence of such actors would be questionable in Europe's ubiquitous family-controlled business groups. But the Parliament also seemed to think that the courts could not properly do the job alone. Instead, the Parliament seems to have felt that it was necessary to call upon non-judicial "competent authorities" to ensure a vigorously critical evaluation of the fairness of intragroup transactions involving financial institutions. In this way,

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78. *See id.*, art 17(1), O.J. L 35/1, at 12 (2003); *id.*, art. 16, O.J. L 35/1, at 12 (2003).

79. *See* Rosa M. Lastra, *The Governance Structure for Financial Regulation and Supervision in Europe*, 10 COLUM. J. EUR. L. 49, 51-52 (2003).

80. *See* Robert E. Mannion & Lisa R. Chavarria, *Transactions Between Banks and Affiliated Entities*, *in* REGULATION OF FOREIGN BANKS: UNITED STATES AND INTERNATIONAL 1121 (Michael Gruson & Ralph Reisner eds., 2003); *see also* Federal Reserve Act, 12 U.S.C. § 371c(c)(1) (2000).

81. *See* Supplementary Supervision Directive, art. 5(2), O.J. L 35/1, 6 (2003) ("[E]very regulated entity which is at the head of a financial conglomerate; every regulated entity, the parent undertaking of which is a mixed financial holding company which has its head office in the Community; [and] every regulated entity linked with another financial sector entity by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC" is subject to supplementary supervision).

the Directive speaks volumes about what the EU has learned about corporate governance through its own experience.[82]

III. *A PROPOSAL FOR REFORM*

As discussed above, the example of the regulatory structure in the EU, where large family-owned pyramid structures dominate the corporate environment, is quite fitting for comparison with other areas of the world where pyramids are widespread.[83] Partly for this reason, this Article borrows some of the concepts of the EU Directive to propose a general regulatory structure specifically designed to reduce the private financing benefits reaped by members of business groups through financial affiliates. Such a law should begin by requiring controlling shareholders of business groups with significant finance-related activities (including activities in the insurance sector) to provide disclosure of all significant transactions by privately and publicly-held financial affiliates and their offshore subsidiaries. These transactions should be subject to a potential fairness scrutiny by regulators within an independent specialized bureau, which would compare the terms of related transactions to similar arms-length transactions and judge their fairness on that basis.[84] Both

82. The EU experience leading to the passage of the Directive is also ripe for comparison with other areas of the world where pyramids are widespread. After all, the judiciaries of most EU Member States are likely to be equally well equipped, and perhaps better equipped, to fairly judge such matters compared to other such countries. Bernard Black and Reinier Kraakman point out that many developing countries do not have a judiciary with enough independence or sophistication in corporate matters to consistently judge the fairness of complicated transactions. *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1925-26 (1996). Similarly, there is no reason to believe that the independent directors of other countries where pyramids are prevalent would be any more "independent" than those in EU Member States.

83. *See generally* CONCENTRATED CORPORATE OWNERSHIP, *supra* note 13; THE CONTROL OF CORPORATE EUROPE, *supra* note 17. In contrast, the strength of the U.S. regulatory structure is dependent in part on the roles played by reputational intermediaries such as accounting firms and lawyers, which helps explain legislation such as the Public Company Accounting Reform and Investor Protection Act of 2002 ("Sarbanes-Oxley"). While the motives behind the passage of Sarbanes-Oxley are certainly understandable in the U.S. context, one would hardly expect it to be passed in countries where the role of reputational intermediaries is much less pronounced due to the weak roles played by the equity markets. Rather, the EU Directive would be a much more relevant and effective role model.

84. The ideal monitoring body proposed here is an "independent specialized bureau," rather than the courts, because in many countries the general courts are not sophisticated or developed enough to evaluate the fairness of complicated corporate

"significant finance-related activities" and "significant transactions" should be defined at a low threshold to minimize any loopholes. The latter's definition should include debt guarantees or any other transactions by which collateral is pledged on behalf of an affiliate. Furthermore, "controlling shareholder" should be defined loosely to include in its ambit any and all firms under that shareholder's direct or indirect control, including offshore subsidiaries. "Affiliate" should also be defined loosely to include those firms whose directors or officers are related to the controlling shareholder.

If the regulators discover an unfair transaction on the aforementioned criteria, they should be authorized to take "necessary measures" such as restitution of the transaction or payment of the estimated subsidy, along with adequate penalties. Such actions would ideally be done by consent decree, and would be reviewable by the courts (ideally on a deferential standard, since courts are generally not experts on the fairness of transactions).[85] Of course, proper enforcement of the disclosure requirement would be a key element to the success of the law. To this end, the law should include a provision allowing regulators to trace the bank accounts of regulated entities, and it should also incorporate a strict liability standard for non-disclosure similar to the strict liability standard of the U.S. Securities and Exchange Commission ("SEC") for material misstatements in prospectuses.[86] That is, if any significant transaction involving a financial affiliate is not disclosed, such a transaction would be deemed presumptively illegal if caught, regardless of whether these transactions are done on ostensibly fair terms or not.[87] This strict liability standard would stimulate disclosure and help

transactions. *See, e.g.*, Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1106 (2004). The monitoring body should be staffed by independent experts in corporate transactions and financial institutions, quasi-judicial in nature because it would rule on the legality of transactions, would be outside the general judicial system, and ideally free of domination by any particular political party or business group. A good example of a body which operates in this manner is the U.S. Federal Trade Commission.

85. Judicial review should be cursory and deferential in light of the bureau's expertise in financial transactions and the large number of decisions rendered, similar to how federal courts in the United States exercise review over the huge number of decisions by administrative law judges. *See* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843 (1984).

86. *See, e.g.*, 15 U.S.C. § 77l(a)(2) (2000).

87. Again, it would be important to define "significant transaction" at a low thresh-

compensate for the difficulty in discovering undisclosed transactions.

Admittedly, such a law might appear draconian, at least at first glance, and it might also be criticized as over-regulation. Even firms that are subject to U.S. disclosure standards are not subject to having their financial transactions regularly reviewed for fairness by a specialized government bureau as this proposal requires. Rather, the SEC merely requires disclosure of certain significant transactions,[88] the U.S. Federal Trade Commission ("FTC") only engages in a tiny number of ad hoc investigations,[89] and U.S. courts are bound by state business judgment rules when derivative suits are brought.[90] Yet, it should be noted that a discernible movement already exists among certain firms in countries to voluntarily list on exchanges with greatly increased standards of disclosure, and this movement tends to negate the inference that the burdens of increased disclosure necessarily outweigh the potential benefits.[91]

With that said, there is no denying that such a regulation would be a significant addition to the disclosure "burden" placed upon listed firms, since it would require disclosing details of any significant transaction involving financial affiliates. The bulk of the added burden would be put on unlisted affiliated financial institutions, since these affiliates would have previously been subject to little if any disclosure save for minimal regulations such as those concerning capital adequacy requirements. As the experience of the EU Banking Directive attests, however, such a burden is hardly impossible to meet, and requiring that the transactions between financial institutions and affiliates be subjected to a potential "fairness" review by government regulators is hardly radical.

Another potential criticism of the proposed regulation is

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old so that difficulty in determining whether a transaction is "significant" would not amount to a loophole.

88. *See* 15 U.S.C. § 78(p) (2000).

89. *See* Alan A. Fisher & Robert H. Lande, *Efficiency Considerations in Merger Enforcement*, 71 CAL. L. REV. 1580 (1983).

90. *See* Kamen v. Kemper Fin. Services, Inc., 500 U.S. 90, 101-07 (1991).

91. John Coffee refers to this phenomenon as "bonding," and points out that non-U.S. firms often list on U.S. exchanges because the added disclosure requirements and prestige involved in doing so often result in an increase in the firm's share value. *See* John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 673-75 (1999).

that it would severely restrict pyramidal business groups' access to finance. Such an argument essentially admits, however, that controlling shareholders in such groups enjoy preferential terms of finance from their financial affiliates. To be clear, the proposed law does not cut off the flow of finance from these financial affiliates, it just ensures that transactions are done on fair terms. Controlling shareholders would also remain free, of course, to tap into the capital of the financial institutions of other domestic or foreign business groups, capital markets abroad, or domestic capital markets as increased disclosure quality gradually reduces the perceived risk and increases the amount that the public is willing to pay for shares.[92] All of these trends would be in a positive direction.[93]

Finally, some would argue that it is naïve to think that a group of regulators with finite resources would be able to catch all the undisclosed transactions, or, that the strict liability standard is too strict. These criticisms are inter-related. Of course, it is not expected that regulators will be able to monitor every disclosed transaction, much less catch the ones that are improperly undisclosed—just as the SEC in the United States is not expected to thoroughly investigate every filing it receives.[94] Rather, the goal is simply to reduce the amount of cross-subsidi-

92. *See* CHANG, *supra* note 24, at 231-36, 238-40; La Porta et al., *supra* note 4, at 1148 (stating that large publicly traded firms get external debt finance in almost all countries, such as from the government and its banks, regardless of legal rules). Even if the controlling families of two separate pyramids worked out a deal whereby they would offer each other cheap terms of finance, such a relationship would still have less dangerous corporate governance implications than if such transactions were made between affiliates, and these arms-length transactions would be much less likely to contribute to a sustained expansion of the pyramid.

93. An increased use of the capital markets would be a desirable trend from a monitoring standpoint as shareholder rights are improved, especially if the financial institutions are taken public and their transactions are checked by outside monitors. Assuming that the controlling shareholders would still retain control over all the pyramids' firms, such a trend might increase the ownership and voting rights gap in the short run. But a reduction of the amount of non-arms-length transactions involving financial affiliates would lead to a corresponding abatement in the pyramid's ability to enjoy advantageous terms of financing solely resulting from the affiliation of a financial institution. Thus, the size of the pyramid—and the amount of minority shareholders that could be expropriated—would gradually diminish in the long run. *See, e.g.*, CHANG, *supra* note 24, at 238 (stating that "*chaebols* are creatures of market imperfections and government intervention . . . as these forces diminish, *chaebols* will decline in the long run.").

94. *See* James D. Cot et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 751-52 (2003).

zation occurring through financial affiliates to the lowest level possible. To this end, the strict liability rule would have a strong deterrent effect because controlling shareholders would know that, if caught, they would be punished for enacting any undisclosed intra-group transaction involving financial affiliates, and not just those transactions that are caught and then found to be "unfair." In a sense, the system could be analogized to enforcing speed limits on the highway, which is also done on a strict liability standard (i.e. the inquiry is simply whether the driver violated the speed limit, and not one of "recklessness"). While it is not expected that all speeding violations will be caught, the fact that some are caught has an overall deterrent effect and encourages would-be violators to abide by the rules.

Needless to say, the scope of the proposed regulatory structure goes well beyond mere improvements in investor protection, but should be employed alongside such measures and would address minority shareholder expropriation in a more indirect way. Yet, while these protections enhance the ability of shareholders to address expropriation after it happens,[95] the proposed regulation would instead focus upon discouraging the expansion of pyramids that leads to the incentive for expropriation in the first place. The proposed structure would put a stop to the continual cycle by which pyramids' advantageous terms of capital stemming improperly from financial affiliates encourage the addition of firms and growth of existing firms in the pyramid, which are in turn taken public but kept under the control of the family, leading to more expropriation.

IV. *PUTTING IT ALL IN CONTEXT: THE EXAMPLE OF KOREA*

A. *Preliminary Observations of the* Chaebol

At this point, it is instructive to provide a concrete illustration of how such a law could be used to address business group control over financial institutions, and why such a law might be particularly effective in the context of pyramidal business structures with financial affiliates. As its example, this Article focuses

95. *See, e.g.*, Coffee, *supra* note 92, at 673-75; Amir N. Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L L. 195, 210-14 (2004). *See generally* Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000).

on Korea, whose economy is now undergoing the somewhat awkward transition from a developing to a developed country, and thus stands at a unique juncture for examination through the lens of corporate governance. Korea, whose corporate landscape is dominated by numerous pyramidal business groups controlled by families with the aid of financial affiliates, called *chaebol*, provides a perfect backdrop to apply the theory above because it has enacted numerous corporate legal reforms designed to guard against expropriation in these *chaebol*.[96] Throughout the 1990s and particularly in the wake of the Asian financial crisis, Korea has witnessed improved corporate governance in the form of increased shareholder protection and a strengthened role for independent directors, as well as attempts by the government to reduce the financing advantage that the *chaebol* receive through their affiliation with NBFIs.[97] As this Article argues, however, these measures have fallen short.

At first glance, the Korean business environment may hardly seem to be in dire need of corporate reform, especially in light of headlines proclaiming, for instance, Samsung Electronics' US$10 *billion* in net income in 2004, greater than that of either Microsoft or Intel.[98] Yet, it goes without saying that the impressive performance of a few business groups in Korea simply cannot be equated with good corporate governance. In the specific context of Korea, it should be remembered that not so long ago, Korea's corporate governance framework was decried by domestic and international observers alike as contributing to a financial crisis that ultimately resulted in an International Monetary Fund ("IMF") bailout.[99] Although Korea has progressed since

96. *See* Licht, *supra* note 95, at 209-15.

97. In using the experience of Korea as an example for others, it should be pointed out that the structure of Korea's financial market exhibits an important difference compared to that of many other countries where pyramids are prevalent—mainly, Korean law prohibits business groups from owning large stakes in commercial banks, and this prohibition does not exist in certain other countries. *See, e.g.*, discussion *infra* note 109. Even so, the experience of Korea can serve as an apt example even for this latter group of countries, because the financing theory proposed above concerns the financing advantage that can obtained through all types of financial institution affiliations, regardless of their identity as banks or NBFIs.

98. *See* James Brooke & Saul Hansell, *Samsung is Now What Sony Once Was*, N.Y. TIMES, Mar. 10, 2005, at C1; Evan Ramstad et al., *Standing Firm: Despite Pressure, Samsung Resists Changing Its Ways*, WALL ST. J., Mar. 16, 2005, at A1.

99. *See* Ha-Joon Chang & Hong-Jae Park, *An Alternative Perspective on Government Policy towards the Chaebol in Korea: Industrial Policy, Financial Regulations and Political De-*

then in its attempts to empower minority shareholders and strengthen the role of independent directors, the gap between ownership and voting rights remains as wide as ever. Partly as a result, the shares of Korea's many listed firms, a few of which are listed on prestigious exchanges overseas, continue to suffer from a so-called "Korea discount" of roughly twenty percent by some estimates.[100] Furthermore, one well-known empirical study which attempted to quantify private benefits of control in various countries estimated such benefits to be, on average, thirty-three percent of total market capitalization for Korean firms with dual-class shares.[101] The author deemed this percentage to be "alarmingly high."[102] Because of the disproportionate impact of the *chaebol* on corporate governance in Korea and their dominance in Korea's economy, no discussion of Korea's financial environment would be possible without a focused look at the structure of Korea's *chaebol*, and particularly, the role that their control over NBFIs played in their growth. Because general histories of the *chaebol* have been presented extensively elsewhere, the latter inquiry will be the focus here.[103] It should first be pointed out, however, that by all measures, the *chaebol* have played a vital role in helping the Korean economy grow at an extraordinary rate—from a per capita income of US$80 in 1960 to US$10,543 in 1996.[104] In particular, their organizational

mocracy, *in* COMPETITION AND CORPORATE GOVERNANCE IN KOREA: REFORMING AND RESTRUCTURING THE CHAEBOL 24, 43-44 (Sung-Hee Jwa & In Kwon Lee eds., 2004).

100. *See, e.g.*, Anna Fifield, *Korea Exchange Seeks Foreign Capital*, FIN. TIMES, Mar. 18, 2005, at 32.

101. Tatiana Nenova estimated the average private benefits of control observed in eighteen countries in 1997 by taking the total value of the votes in a control block and calculating the differences in value between voting and non-voting shares. Using this methodology, Nenova asserted that Korea had "alarmingly high values of control," at roughly one third of company market capitalization. *See* Nenova, *supra* note 18, at 38, 53. Using a different technique, Alexander Dyck and Luigi Zingales estimated the average value of control in thirty-nine countries between 1990 and 2000 by studying the price at which controlling blocks were sold in publicly traded companies. They estimated that the average private benefits of control in Korea at around fourteen percent of company market capitalization. *See* Dyck & Zingales, *supra* note 12, at 568.

102. *See* Nenova, *supra* note 18, at 38.

103. *See, e.g.*, ALICE H. AMSDEN, ASIA'S NEXT GIANT: SOUTH KOREA AND LATE INDUSTRIALIZATION (1989); EUN MEE KIM, BIG BUSINESS, STRONG STATE: COLLUSION AND CONFLICT IN SOUTH KOREAN DEVELOPMENT, 1960-1990 (1997); Kon Sik Kim, *Chaebol* and Corporate Governance in Korea (Sept. 1, 1995) (unpublished Ph.D. dissertation, University of Washington) (on file with the Marian Gould Gallagher Law Library, University of Washington).

104. Il Chong Nam et al., Corporate Governance in Korea, Presented Before the

structure facilitated efficient allocation of the limited capital and managerial talent that was available until the final decade of the twentieth century, and they provided an expedient mechanism by which the government could direct growth in strategic sectors in the economy.[105] Although various studies have debated the question of whether the *chaebol* invest resources as productively as non-*chaebol*, most observers agree that the efficiency benefits that do exist within *chaebol* structures have eroded since the 1970s.[106] Still, the *chaebol* currently remain crucial drivers of Korea's economy, and the top thirty *chaebol* currently account for roughly forty-five percent of total corporate assets, forty percent of total sales, and twenty percent of total employment in Korea.[107] Each of them controls numerous listed and unlisted firms.

Organisation for Economic Co-operation and Development ("OECD") Conference on Corporate Governance in Asia ¶ 1 (Mar. 3-5, 1999), http://www.oecd.org/dataoecd/7/38/1931564.pdf (last visited Oct. 1, 2006).

105. *See, e.g.*, CHANG, *supra* note 24, at 91-94; Curtis J. Milhaupt, *Property Rights in Firms*, *in* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE, *supra* note 62, at 210, 226.

106. Even today, there is widespread disagreement on whether the *chaebol* have invested resources more efficiently than non-*chaebol*. Many empirical analysts argue that the tendency of the *chaebol* to over-invest and diversify across many industries lowers their profitability and productivity. *See, e.g.*, Sung Wook Joh & Euysung Kim, *Corporate Governance and Performance in the 1990s*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL 102, 113, 115-16 (Stephan Haggard et al. eds., 2003); Jeong-Pyo Choi & Thomas G. Cowing, *Firm Behavior and Group Affiliation: The Strategic Role of Corporate Grouping for Korean Firms*, 10 J. ASIAN ECON. 195, 206-07 (1999); Stephen P. Ferris et al., *The Costs (and Benefits?) of Diversified Business Groups: The Case of Korean Chaebols*, 27 J. BANKING & FIN. 251, 253 (2003); Sung Wook Joh, *Corporate Governance and Firm Profitability: Evidence from Korea Before the Economic Crisis*, 68 J. FIN. ECON. 287, 290 (2003). Others stress that in comparison to non-*chaebol*, the *chaebol* have benefited from various advantages such as economies of scale and higher labor productivity. *See, e.g.*, AMSDEN, *supra* note 103, at 151-53; Sea Jin Chang & Unghwan Choi, *Strategy, Structure and Performance of Korean Business Groups: A Transactions Cost Approach*, 37 J. INDUS. ECON. 141, 142 (1988); Sea Jin Chang & Jaebum Hong, *Economic Performance of Group-affiliated Companies in Korea: Intragroup Resource Sharing and Internal Business Transactions*, 43 ACAD. MGMT. J. 429, 445 (2000). Whatever the case, any efficiency benefits arising from conglomerate structures—even assuming they exist—must be weighed against the corporate governance implications of how these conglomerates are managed and owned. In that light, it is instructive to note that most observers, including the ones listed above, suggest (or at least do not deny) that the productivity advantages of *chaebol* firms over the market as a whole have declined. *See* Inhak Hwang & Jung-Hwan Seo, *Corporate Governance and Chaebol Reform in Korea*, 13 SEOUL J. ECON. 361, 379 (2000) (concluding on the basis of their empirical analysis of the financial structures of the top thirty *chaebol* that the efficiency benefits of *chaebol* organization began to be outweighed by corporate governance drawbacks in the early 1990s).

107. *See* Jongryn Mo & Chung-in Moon, *Business-Government Relations Under Kim*

How did *chaebol* become so large, and how have they maintained their continued growth to this day? The answer, as will be argued here, is at least partially explained by the uncanny ability that controlling families have displayed in maintaining preferential terms of finance and large stores of internal capital markets through the progression of Korea's ever-changing financial environment. It all began in the early stages of Korea's economic development, when the *chaebol* enjoyed a virtual monopoly over capital. When the Park Chung Hee government came to power in the early 1960s and nationalized banks as a means of development policy, it set artificially low interest rates for the banks and directed these loans to favored business groups, which invested the capital in certain strategic heavy industries chosen by the government.[108] At the time, the government's rationale for nationalizing the banks was probably to prevent the *chaebol* from taking control over them and thus gaining a source of capital independent of government influence. After the assassination of Park in 1979, his successor Chun Doo Hwan basically kept this policy in place when he privatized the commercial banks but prohibited the *chaebol* from owning a controlling stake in them.[109] Even so, the *chaebol* continued to receive cheap loans from the banks due in part to the perception that the former were a low credit risk—a perception caused in no small part by the widespread belief that the government would come to the rescue if these behemoths were ever in distress—and because the government still exercised influence over the banks' lending decisions.[110]

Dae-jung, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, at 127, 135; Hwang & Seo, *supra* note 106, at 363.

108. *See* Yoon-Je Cho & David C. Cole, *The Role of the Financial Sector in Korea's Structural Adjustment*, *in* STRUCTURAL ADJUSTMENT IN A NEWLY INDUSTRIALIZED COUNTRY: THE KOREAN EXPERIENCE 115, 122, 126-27 (Vittorio Corbo & Sang-Mok Suh eds., 1992); Wonhyuk Lim, *The Emergence of the Chaebol and the Origins of the Chaebol Problem*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, at 35, 44.

109. In 1982, the government placed an eight percent limit on the amount of ownership one could hold own in a national commercial bank, and this limit was later tightened to four percent in 1998. *See* Yung Chul Park & Dong Won Kim, *Korea: Development and Structural Change of the Banking System*, *in* THE FINANCIAL DEVELOPMENT OF JAPAN, KOREA, AND TAIWAN: GROWTH, REPRESSION, AND LIBERALIZATION 188, 195 (Hugh T. Patrick & Yung Chul Park eds., 1994).

110. Commercial banks were discouraged from taking active monitoring roles through equity stakes, since the government effectively told the banks to make loans to certain entities, and the Banking Law prohibited them from owning more than ten

Meanwhile, the *chaebol* stood poised to take advantage of another crucial peculiarity of Korea's style of state-guided economic development, one that enabled the *chaebol* to continue enjoying advantageous terms of finance even after the policy loans dried up. That is, the artificially low interest rates that were enforced upon banks by the government led to a parallel curb market with much higher interest rates, which naturally diverted huge amounts of capital from the regulated financial market. In response, the government greatly liberalized its licensing procedures for establishing NBFIs in the early 1970s, hoping to absorb the curb market and channel these funds back into the regulated market. The government did not place the same restrictions on *chaebol* ownership of NBFIs, however, and the *chaebol* voraciously seized on this opportunity to gain reliable sources of capital independent of government influence.[111] Because NBFIs could offer depositors much higher interest rates than the highly regulated banks, they rapidly grew in size and soon began to overtake commercial banks in terms of deposits. For example, from 1975 to 1993, the percentage of Korea's total financial savings entrusted to banks in the form of deposits declined from sixty percent to twenty-four percent, while the share of deposits in NBFIs rose from twenty-eight percent to sixty-eight percent.[112] The advantages reaped by the *chaebol* through NBFIs further increased throughout the 1990s, when the government granted licenses to twenty-four additional merchant banks (which were mostly owned by the *chaebol*, of course) and en-

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percent of the equity of non-financial firms (later raised to fifteen percent in 1998). *See* Myeong-Hyeon Cho, *Reform of Corporate Governance*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, at 286, 294; Park & Kim, *supra* note 109, at 195-96; Nam et al., *supra* note 104, ¶ 97.

111. *See* Choon Taik Chung, *Financial Sector Reforms and Liberalization in The Republic of Korea: Current Status and Prospects*, *in* FINANCIAL SECTOR REFORMS, ECONOMIC GROWTH, AND STABILITY: EXPERIENCES IN SELECTED ASIAN AND LATIN AMERICAN COUNTRIES 261, 262-63 (Shakil Faruqi ed., 1994); Joon-Ho Hahm, *The Government, the Chaebol, and Financial Institutions Before the Economic Crisis*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, 79, 83-87; Byung-Kook Kim, *The Politics of Chaebol Reform, 1980-1997*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, at 62; Lawrence J. White, *Structure of Finance in Selected Asian Economies*, *in* FINANCIAL SECTOR DEVELOPMENT IN ASIA 37, 60, 90-92 (Shahid N. Zahid ed., 1995); XIAOKE ZHANG, THE CHANGING POLITICS OF FINANCE IN KOREA AND THAILAND: FROM DEREGULATION TO DEBACLE 93 (2003).

112. *See* Won-Am Park, *Financial Liberalization: The Korean Experience*, *in* FINANCIAL DEREGULATION AND INTEGRATION IN EAST ASIA 247, 254 tbl.9.4 (Takatoshi Ito & Anne O. Krueger eds., 1996).

couraged them to raise funds in foreign capital markets.[113] These actions were perhaps due to its fear that foreigners would take over Korean financial institutions after financial regulatory barriers were lifted in the early 1990s under U.S. pressure.[114] The growth of *chaebol*-affiliated NBFIs further increased in 1996, when the Kim Young Sam government loosened restrictions on *chaebol* ownership of insurance companies and investment trusts,[115] and the use of investment trusts exploded during the Asian financial crisis as a method by which to prop up affiliates.

A few statistics are instructive: in the period between 1980 and 1988, the percentage of Daewoo's assets attributed to financial services companies jumped from seven percent to thirty-nine percent, and the corresponding percentage for Samsung jumped from twenty-one percent to forty-five percent.[116] By the early 1990s, NBFIs replaced commercial banks as the principal source of loans to the corporate sector, and about half the assets of the life insurance industry were dedicated to loans.[117] By the time of the financial crisis, the seventy largest *chaebol* owned 140 NBFIs, with thirty of these NBFIs owned by the top five *chaebol* alone.[118] The crisis itself was marked by a huge increase in *chaebol* use of investment trust companies to prop up ailing affiliates, but many of these NBFIs were shut down or merged, and the public had to bear much of the bad debt.[119] More recently, the credit card debt crisis that has afflicted Korea has made some of the NBFIs seem more like liabilities than assets to their *chaebol* affiliates. However, such cycles come and go, and many *chaebol*-affiliated NBFIs—particularly insurance companies—maintain their cash cow status regardless of the economic climate.[120] Sam-

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113. Gregory W. Noble & John Ravenhill, *The Good, the Bad and the Ugly? Korea, Taiwan and the Asian Financial Crisis*, *in* THE ASIAN FINANCIAL CRISIS AND THE ARCHITECTURE OF GLOBAL FINANCE 80, 94 (Gregory W. Noble & John Ravenhill eds., 2000).

114. *See* Byung-Kook Kim, *supra* note 111, at 63.

115. *See* Cheung H. Lee et al., *Chaebol, Financial Liberalization, and Economic Crisis: Transformation of Quasi-Internal Organization in Korea* 11 (Seoul Nat'l Univ. Inst. of Econ. Research, Working Paper No. 31, 2000), http://ideas.repec.org/p/snu/ioerwp/no31.html (last visited Oct. 1, 2006).

116. *See* EUN MEE KIM, *supra* note 103, at 189.

117. *See* White, *supra* note 111, at 91.

118. *See* CHANG, *supra* note 24, at 61; Hahm, *supra* note 111, at 87.

119. *See, e.g.*, Stijn Claessens, *Financial Reform: Progress and Challenges*, *in* KOREA'S ECONOMY, 2000, at 22, 23 (2000); Nam et al., *supra* note 104, ¶ 21, 101.

120. A fitting comparison is that of between the current status of Samsung Card and Samsung Life. The former is a credit card provider that has lost money for the last

sung Life, for example, currently boasts assets of over US$80 billion,[121] and Kyobo Life is not far behind.[122]

The point is this: while the initial growth of many of Korea's *chaebol* can be largely attributed to policy loans extended by the government well into the 1980s, the ability of the *chaebol* to continue expanding at exponential rates resulted partly from their ability to continue receiving cheap finance with little accountability from affiliated NBFIs. While it may be true that the perception that the *chaebol* were too big to fail did contribute somewhat to the advantageous terms of external loans they received, it was their control over lucrative NBFIs that has given many of the *chaebol* firms a nearly insurmountable financing advantage over independent firms.

B. *The Role of Financial Institutions in the Growth of the* Chaebol

To this day, the controlling families of *chaebol* have utilized their control over NBFIs to (1) maintain their ownership over large numbers of firms through the shareholdings of the NBFIs, and (2) provide cheap finance to affiliates through cross-subsidization. In terms of the former, the families have often used their NBFIs as modified holding companies, taking advantage of the large reserves of cash to buy up the equity of affiliates. Although the use of holding companies is restricted in Korea,[123] it is not uncommon to see nearly half the equity portfolios of NBFIs invested in affiliates.[124] Various reports on the circular-shareholding structures of the *chaebol*, such as data published by the Fair

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several years and has required cash infusions of over US$1 billion from Samsung Electronics in the past two years to stay afloat. *See* Ramstad, *supra* note 98, at A1. Samsung Life, on the other hand, boasted assets of over 83 trillion won (US$82 billion) as of fiscal year 2003. *See* Financial Services, Samsung Life Insurance Co., Ltd., http://www.samsung.com/AboutSAMSUNG/SAMSUNGGroup/AffiliatedCompanies/FinancialServices/LifeInsurance.htm (last visited Oct. 1, 2006).

121. As of fiscal year 2003, Samsung Life had assets of over 83 trillion won (US$82 billion). *See* Financial Services, Samsung Life Insurance Co., Ltd., *supra* note 120.

122. *See* Kyobo Life Annual Report 2003, http://www.kyobo.co.kr/introduction/ciencifian_annual.do# (last visited Oct. 1, 2006).

123. *See* Monopoly Regulation and Fair Trade Act, Act No. 3320 arts. 8 to 8-3 (1980) (S. Korea) [hereinafter Fair Trade Act].

124. For example, the cross-holdings of Samsung-affiliated NBFIs play an important role in maintaining the Lee family's control over the Samsung *chaebol* as a whole. *See* PEOPLE'S SOLIDARITY FOR PARTICIPATORY DEMOCRACY, HANGUKUI CHAEPOL: KICH'OCHARYO SUCHIP, BUNSOK MIT P'YONGGA [KOREA'S CHAEBOL: A COLLECTION OF BASIC DATA, ANALYSIS AND EVALUATION] 78 (2003).

Trade Commission and the shareholder activist group People's Solidarity for a Participatory Democracy ("PSPD"),[125] shed light on the widespread use of NBFIs in this way; as do empirical studies such as one conducted by three economists from the Korea Development Institute and the Korea Advanced Institute of Technology.[126] In their study of the ownership structures of the forty-six largest *chaebol* between 1997 and 2002, in which they studied data on the equity holdings of unlisted NBFIs, these economists found that controlling shareholders purposely concentrated their cash flow rights in (often unlisted) firms that served as de facto holding companies, and these firms were usually affiliated NBFIs.[127] Other empirical studies have found similar results.[128]

The second way in which controlling families have utilized their control over NBFIs has been to cross-subsidize affiliates through below-market terms of finance. This can be done using a variety of methods, but some of the more obvious ways have involved directing NBFIs to provide loans to affiliates at systematically below-market interest rates, or refraining from charging any interest at all for certain periods. For example, several NBFIs within the Daewoo Group were caught doing this in the late 1990s;[129] and, in the midst of the financial crisis, Daehan Life Insurance was discovered to have made loans of US$2.7 billion to its affiliates with the SK Group, an amount that was far above the limit allowed by law at the time, and all of which had to be later written off.[130] Yet another cross-subsidization method has involves directing NBFIs to purchase the bonds and promissory notes of affiliates at below-market interest rates. Samsung

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125. For the People's Solidarity for Participatory Democracy ("PSPD") publication, see *id.* Korea's Fair Trade Commission publishes its reports on its website at http://www.ftc.go.kr/eng.

126. *See generally* Woochan Kim, Youngjae Lim & Taeyoon Sung, *What Determines the Ownership Structure of Business Conglomerates?: On the Cash Flow Rights of Korea's Chaebol* (Eur. Corp. Governance Inst., Working Paper No. 51, 2004), http://ssrn.com/abstract=594741 (last visited Oct. 1, 2006).

127. *See id.* at 2-3, 30.

128. *See, e.g.*, Daehong T. Jaang et al., *Cross Shareholding and Corporate Financial Policy: The Case of Korea* 16 (Sungkyunkwan Univ., Working Paper No. 2002-02, 2002), http://biz.korea.ac.kr/%7Eaicg/paper_2nd/Cross_shareholding_and_corporate_financial.pdf (last visited Oct. 1, 2006).

129. *See* CHANG, *supra* note 24, at 151.

130. *See* Hahm, *supra* note 111, at 88.

and Daewoo have been particularly fond of using this method,[131] though Daewoo was perhaps the worst abuser. Not only did Daewoo use NBFIs such as Daewoo Capital, Daewoo Securities, and Diners Capital to this end,[132] but it also secretly used an NBFI called Seoul Investment Trust Company to purchase billions of dollars worth of bonds and commercial paper issued by Daewoo affiliates in 1998 and 1999. All of them had to be written off after Daewoo's collapse.[133] A third cross-subsidization method has been to direct an NBFI to issue debt guarantees on behalf of affiliates with little or no consideration.[134] In fact, the prevalence of this practice in Korea led one respected scholar of Korean corporate governance to remark in the mid-1990s that it is "well-established" that the debts of *chaebol* firms are guaranteed by affiliate firms with no pecuniary consideration at all.[135]

Showing no lack of creativity, the *chaebol* have also employed more indirect methods. For example, the Samsung Group orchestrated a deal with several commercial banks, whereby Samsung Life extended subordinated loans to these banks, which in turn purchased the private placement bonds of other Samsung affiliates.[136] Another method that has proven particularly problematic for government regulators has been the heavy use of offshore funds by the *chaebol*. Many of these offshore funds are set up by *chaebol*-affiliated NBFIs and operated in an opaque manner, and their subsidization of affiliates has been particularly difficult to catch.[137] Also, *chaebol* families can use

131. For example, Sea-Jin Chang documents that between January and July 1997, 69.3 percent of all of Samsung Securities' bond acquisitions was of Samsung affiliates, and the corresponding figure for Daewoo Securities' bond acquisitions of Daewoo affiliates was 51.1 percent. In this way, these securities houses functioned as secure sources of financing for their affiliates. *See* CHANG, *supra* note 24, at 138.

132. *See id.* at 151.

133. *See* Dong Gull Lee, *The Restructuring of Daewoo*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, at 154, 175.

134. Although Article 10-2 of the Monopoly Regulation and Fair Trade Act ("Fair Trade Act") currently prohibits debt guarantees among affiliates, it exempts from its terms financial institutions, which are instead regulated by other laws that generally allow them to extend debt guarantees to affiliates to a certain extent. *See* Fair Trade Act, No. 3320 art. 10-2 (1980) (S. Korea).

135. *See* Kim, *supra* note 103, at 136-37. Article 10-2 of the Fair Trade Act has since prohibited debt guarantees among firms in large *chaebol*, but financial institutions are currently exempt from its terms.

136. *See* CHANG, *supra* note 24, at 153.

137. *See* Nam, *supra* note 104, ¶ 99 (noting that the *chaebol* "have been using their

their control over the NBFIs to manipulate the prices of affiliate stocks held by the latter. For example, in 1999, Hyundai Securities was found to be manipulating the stock price of several Hyundai affiliates, including Hynix, for the family's gain.[138] Finally, rumors that Samsung Life wanted to go public ignited a hot debate on whether and how the proceeds should be allocated between policyholders and shareholders (the vast majority of which are members of the Lee family or Samsung affiliates). The confusion is partly due to the organization of Korean insurance companies as corporations, rather than mutual companies, and the fact that many of the insurance policies contain an element of investment profit-sharing.[139] The Chairman of the Samsung Group had originally wanted to take Samsung Life public to help pay off the enormous debts incurred by Samsung Motors, after a controversial transaction in which he sold his shares in Samsung Life to Samsung Motors creditors at a price later viewed as grossly inflated.[140]

C. *The Aftermath of* Chaebol *Growth*

By and large, it is evident that these connections have allowed *chaebol* affiliates to access credit lines far in excess of their equity or what their financial health would normally allow. This phenomenon, to say the least, has limited the disciplinary ability of the market.[141] Yet, with the exception of the most obvious and egregious cases, it is often difficult to gather exact data on

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affiliated MBCs, especially their overseas branches, and to a lesser extent their insurance companies, to finance the activities of other subsidiaries within their groups."); Kim Ji-Hyun, *Companies Caught Illegally Operating Offshore Funds*, KOREA HERALD, Sept. 9, 2002; Yon-Se Kim, *Financiers' Losses From Offshore Funds Surge*, KOREA TIMES, Sept. 9, 2002.

138. *See Finance and Economics: Murkier and Murkier*, ECONOMIST, Sept. 11, 1999, at 76-77; Yon-Se Kim, *Minority Shareholders Win Damage Suit Against Hyundai*, KOREA TIMES, Dec. 11, 2003. Five researchers at the Korea Development Institute have also listed other ways in which the *chaebol* have used their control over NBFIs to finance affiliates, including, "priority underwriting of securities issued by related subsidiaries, provision of preferential financial services and information on competing firms, [and] management of related firms' shares and their prices." Nam, *supra* note 104, ¶ 99.

139. *See* Semin Park, *Going Public and Listing of Life Insurance Companies on Stock Markets and Profit Sharing in Korea: A Legal Study*, 14 COLUM. J. ASIAN L. 129, 131-35 (2000).

140. *See Creditors Facing Tough Going in Selling Samsung Life Shares*, KOREA HERALD, Apr. 23, 2001; Song-Soo Park, *Taxpayers Write Off Samsung Motor's Debts*, KOREA TIMES, Jan. 15, 2001.

141. *See* Joh & Kim, *supra* note 106, at 110.

the extent to which NBFI capital has been siphoned off to affiliates, due in no small part to the lack of transparency. In conducting this inquiry, one place to start is the series of four investigations of the top five *chaebol* conducted by Korea's Fair Trade Commission between 1998 and 2000.[142] These investigations covered all transactions, and not just those involving NBFIs, but by way of background it is helpful to note that the Commission found a total of 20.3 trillion won (US$14.5 billion) of what it classified as unfair business transactions between the firms of these five *chaebol* alone, which it estimated resulted in a total of 640 billion won (US$457 million) in direct cross-subsidies.[143] In many of these cases, publicly traded firms were subsidizing privately held firms.[144] Furthermore, several empirical studies have been conducted that shed light specifically on the cross-subsidization role of NBFIs such as one published in the late 1990s by Joon-Kyung Kim.[145] This study found that throughout the 1990s, *chaebol* firms with NBFI affiliates systematically borrowed at a significantly lower rate than firms that were not affiliated with NBFIs.[146] Although the lower terms at which *chaebol* could borrow can be partly explained by the fact that banks viewed the *chaebol* as lower bankruptcy risks (due in part to the perception that the government would come to their rescue in times of distress), Kim's study found a sudden large increase in the interest rate gap in the late 1990s which he attributed to the *chaebol*'s manipulation of their control over NBFI in the distressed environment of the Asian financial crisis.[147]

Furthermore, several empirical studies have shed light specifically on the cross-subsidization role of NBFIs such as one conducted in the late 1990s by Joon-Kyung Kim.[148] They interpreted the data as evidence of crony relationships between

142. *See* CHANG, *supra* note 24, at 126-29.

143. *See id.* at 128. These figures would have been even higher had Daewoo not gone bankrupt in 1999. *See id.* The exchange rate has been calculated at US$1=1400 won, which was roughly the average for the 1998-2000 period.

144. *See id.* at 129.

145. *See* Joon-Kyung Kim, *Assessment of Progress in Corporate Restructuring in Korea Since the 1997-98 Crisis*, *in* EMPIRICAL EVALUATION OF CORPORATE RESTRUCTURING 47, 56 (Stijn Claessens & Dongsoo Kang eds., 2003).

146. *See id.*

147. *See id.*

148. *See* Ming Ming Chiu & Sung Wook Joh, *Loans to Distressed Firms: Cronyism, Related Lending and Bank Governance* 2, 6 (Hitotsubashi University, Graduate School of Economics, Working Paper No. 44, 2004) (on file with author).

NBFIs and their non-financial affiliates.[149] In yet another empirical study, Hyun-Han Shin and Young S. Park found that firms within the top thirty *chaebol* were less subject to financing constraints than other firms in the mid-1990s, partly as a result of the contribution of NBFIs to the internal capital markets of these *chaebol.*[150]

As the *chaebol* continued to grow, the families felt comfortable accessing the burgeoning equity markets as long as their control over these firms was guaranteed—easily done, of course, through the use of pyramid structures and circular shareholdings.[151] In fact, despite the argument of some economists that the *chaebol* have over-relied upon debt financing because of their aversion to issuing equity and losing corporate control,[152] the problem was exactly the opposite. That is, *chaebol* families have issued an increasing proportion of their firms' equities while retaining control by using the votes of affiliated firms, and the result has been an increasingly large gap in ownership and voting rights, which, when combined with the increasingly large size of the *chaebol* themselves, has given rise to an increasingly large number of minority shareholders whose investments are indirectly controlled by a *chaebol* family. Thus, the average percentage of *chaebol* equities directly held by the controlling family declined throughout the 1990s, but this decline was easily compensated for by a rise in the percentage of equities held by affiliates.[153] The sad implications of this phenomenon have been enormous from a corporate governance standpoint, as was demonstrated by the ubiquitous headlines in Korea proclaiming the expropriation of increasingly large numbers of minority

149. *See id.*

150. *See* Hyun-Han Shin & Young S. Park, *Financing Constraints and Internal Capital Markets: Evidence from Korean Chaebols*, 5 J. CORP. FIN. 169, 172-73 (1999).

151. Cross-shareholding is prohibited among firms of most of those *chaebol* regulated by the Fair Trade Act. Furthermore, issuing dual class common stock is illegal, and dual class preferred stock has not really taken off in Korea for various reasons. *See, e.g.*, Joongi Kim, *Recent Amendments to the Korean Commercial Code and Their Effects on International Competition*, 21 U. PA. J. INT'L ECON. L. 273 (2000).

152. *See, e.g.*, Seong Min Yoo & Youngjae Lim, *Big Business in Korea: New Learning and Policy Issues* 39-40 (Korean Development Insititute, Working Paper No. 9901, 1999), http://www.kdi.re.kr/kdi/report/report_read05.jsp?1=1&pub_no=971 (last visited Oct. 1, 2006).

153. *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD ECONOMIC SURVEYS: KOREA 2000-2001 135 (2001).

shareholders by *chaebol* families.[154]

The gap between ownership and voting rights continues to this day. In December 2004, the Korean Fair Trade Commission ("KFTC") reported that among Korea's thirty-six *chaebol* with assets in excess of two trillion won (roughly US$2 billion), the respective chairman owned an average of only 1.95 percent of the total shares of the firms within the *chaebol*, with his family owning another 2.66 percent. These tiny equity stakes were hugely supplemented by an average of 41.7 percent control exercised through the circular shareholdings of affiliates.[155] Furthermore, in 469 of the 781 firms that were associated with these thirty-six *chaebol*, the controlling families did not own a single share in the firm yet controlled the firm indirectly through the firm's affiliates.[156] Perhaps the most egregious example of voting and ownership separation was that of Daewoo before its bankruptcy: Chairman Kim Woo-Joong and his family held only 0.04 percent of Daewoo's flagship subsidiary, Daewoo Motors, yet controlled 94.5 percent of its shares through the votes of affiliated compa-

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154. There are too many examples to list, but three will suffice here involving the Samsung Group, the LG Group, and the SK Group. Beginning in 1999, Samsung smoothed its impending father-to-son succession transfer by orchestrating an issuance of 3.21 million convertible bonds of Samsung SDS, a publicly-traded Samsung subsidiary, to Jae-Yong Lee, the son of the Samsung chairman, and other family members at prices far below the going market rate. Thus, the shares of Samsung SDS minority shareholders were diluted, while Jae-Yong Lee's stake in Samsung SDS was raised to 10.1 percent. At around the same time, the controlling family of LG pocketed windfall gains at the expense of LG Chemical's minority shareholders when it arranged a sale of its 1.18 million shares in the unlisted LG-Caltex Oil subsidiary to LG Chemical at a price most observers considered extremely high. LG Chemical's purchase of the family's shares in the unlisted LG Mart subsidiary elicited similar criticism. *See* Cheong-mo Yoo, *Court Ruling Suspends Samsung Group's Father-to-son Power Transfer Attempt*, KOREA HERALD, May 11, 2000; Cheong-mo Yoo, *LG Group Owner Family Learns Lesson from Samsung Chairman's Stock Scandal*, KOREA HERALD, May 12, 2000. Finally, the SK Group was found to be expropriating SK Telecom shareholders by orchestrating transactions between publicly-held SK Telecom and two of its affiliates, Daehan Telecom and SK Distribution, which were virtually wholly owned by the controlling family of the SK Group. Both Daehan Telecom and SK Distribution were found to have charged SK Telecom hugely inflated prices for certain service contracts and equipment. The results were telling: Between 1994 (when the SK Group purchased the predecessor of SK Telecom from the Korean government) and 1997, Daehan's operating income rose from 64 million won to 18.2 billion won. Conversely, SK Telecom's operating margin dropped by over half in the same period. *See* CHANG, *supra* note 24, at 183.

155. *See* Min-hee Kim, *Chaebol Heads Control Empires with Less than 2 Percent Stake*, KOREA HERALD, Dec. 28, 2004.

156. *See id.*

nies.[157]

V. *ADDRESSING CROSS-SUBSIDIZATION WITHIN THE* CHAEBOL: *THE PROPOSED LAW IN CONTEXT*

A. *Recent Legal Reforms Addressing the* Chaebol

As one might imagine, the alarming implications of the huge gap between ownership and voting rights within the *chaebol* have not gone unnoticed by Korea's policymakers and regulators, particularly in the aftermath of the Asian financial crisis.[158] In the wake of the crisis, a huge shakeout of the financial industry took place, with many NBFIs and banks being shut down, merged, or having their default assets bought out by the government's Korea Asset Management Corporation.[159] With IMF prodding, great strides were made in reducing cross-debt guarantees among *chaebol* affiliates,[160] and NBFIs are now required to have audit committees which are at least two-thirds composed of independent directors.[161] Much of the impressive well-publicized progress, however, has occurred in the areas of investor protection and decision-making governance,[162] and these mea-

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157. *See* Ha Sung Jang, Corporate Governance and Economic Development: The Korean Experience, Presented at KDI-World Bank Conference on Democracy, Market Economy, and Development, Seoul, Korea (Feb. 26, 1999), at 5-6, http://idep.kdi.re.kr/conference/program/participants/Jang_Ha_Sung/Jang_Ha_Sung_e_paper_fulltext.htm.

158. *See* CHANG, *supra* note 24, at 190.

159. *See id.* at 192.

160. *See id.* at 190, 202.

161. *See, e.g.*, Specialized Credit Financial Business Act, No. 5374 art. 50-5 (1997), *amended by* Act. No. 6430 (2001) (S. Korea); Insurance Business Act, No. 3043 art. 16 (1977), *amended by* Act. No. 6175 (2000) (S. Korea); Act on Business of Operating Indirect Investment and Assets, No. 6987 art. 12 (2003) (S. Korea).

162. For example, Korean law formerly required at least five percent ownership to exercise basic shareholder rights such as calling a meeting, accessing account books, and perhaps most crucially, filing derivative suits, but shareholders are now allowed to bring shareholders' derivatives suits much more easily, as well as inspect their firm's accounting books and select directors through a cumulative voting system. Furthermore, firms listed on the Korea Stock Exchange or KOSDAQ are required to have boards with at least one-fourth independent directors (and up to one-half for the largest firms), as well as audit committees. *See, e.g.*, Joongi Kim, *Recent Amendments to the Korean Commercial Code and Their Effects on International Competition*, 21 U. PA. J. INT'L ECON. L. 273, 329 (2000); Jae Yeol Kwon, *The Internal Division of Powers in Corporate Governance: A Comparative Approach to the South Korean Statutory Scheme*, 12 MINN. J. GLOBAL TRADE 299, 330-31 (2003); Ok-Rial Song, *The Legacy of Controlling Minority Structure: A Kaleidoscope of Corporate Governance Reform in Korean Chaebol*, 34 LAW & POL'Y INT'L BUS. 183, 225-26 (2002). Suffice it to say that arguments have already arisen

sures have not adequately addressed the vast ownership and voting rights gap. In particular, because a controlling family often funnels control over its pyramid through a privately-owned firm, it is very difficult for outside shareholders to exert any influence on the pyramid structure as a whole. For example, control of the Samsung group is channeled through Samsung Everland, a privately-held firm controlled by the son of the group's chairman.[163]

Seemingly aware of the limits of investor protection measures, the government has also enacted specific measures that address the internal financing advantages enjoyed by *chaebol*. For example, the Monopoly Regulation and Fair Trade Act ("Fair Trade Act") has prohibited new debt guarantees among affiliated non-financial firms in most of the top thirty *chaebol* since 1998.[164] However, the Fair Trade Act currently exempts financial institutions and insurance companies from its terms because their investment and financing activities are regulated by other specialized laws.[165] These specialized laws do not limit the ability of NBFIs to engage in such practices as strictly as the Fair Trade Act. For example, Article 106 of the Insurance Business Act regulates the asset management activities of insurance companies, and it allows insurance companies to issue up to three percent of their equity in loans and debt guarantees to any one affiliate.[166]

None of these laws govern the fairness of financial transactions. For that, Korean lawmakers have focused on giving

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within the legal academy that shareholders have been given too much power vis-à-vis directors. *See, e.g.*, Johneth Chongseo Park & Doo-Ah Lee, *The Business Judgment Rule: A Missing Piece in the Developing Puzzle of Korean Corporate Governance Reform*, 3 J. KOREAN L. 15, 45-47 (2003).

163. *See, e.g.*, Wonhyuk Lim et al., *Introduction: The Political Economy of Corporate Restructuring*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, at 1, 4.

164. *See* CHANG, *supra* note 24, at 155-56; Kwangshik Shin, *Competition Law and Policy*, *in* ECONOMIC CRISIS AND CORPORATE RESTRUCTURING IN KOREA: REFORMING THE CHAEBOL, *supra* note 106, at 265, 273. Each year, the Fair Trade Commission designates which *chaebol* will be designated as "enterprise groups" subject to the various restrictions such as a ceiling on the total amount of cross-shareholding and cross-debt guarantees. *See* Monopoly Regulation and Fair Trade, Act No. 3320 art. 14(1) (1980), *amended by* Act No. 7315 (2004) (S. Korea).

165. *See* Fair Trade Act, No. 3320 art. 10-2 (1980), *inserted by* Act No. 4513 (1992), *amended by* Act No. 5503 (1998) (S. Korea).

166. *See* Insurance Business Act, No. 3043 art. 106 (1977), *amended by* Act No. 5500 (1998) (S. Korea).

greater roles and responsibilities to independent directors and the board of directors as a whole. As previously mentioned, NBFIs are now required to have audit committees at least two-thirds staffed by independent directors,[167] and Article 191-19 of the Securities and Exchange Act now requires board approval for certain transactions with affiliates.[168] Finally, Article 382-3 of the Commercial Code now specifically lays out the fiduciary duties of directors.[169] Although these developments mark a positive trend, the role played by so-called independent directors in zealously reviewing intra-group transactions should be viewed skeptically in any country despite the laws on the books. Korea is no exception. There is no evidence that the increased roles given to independent directors of NBFIs has resulted in a decrease in intra-group subsidization.

The final main strategy used by lawmakers to address the role of *chaebol*-affiliated NBFIs in contributing to the ownership and voting rights gap deals with the *chaebol* families' use of NBFI voting rights.[170] In the wake of the financial crisis up until 2002, the Fair Trade Act prohibited those *chaebol* that were regulated by the Act from exercising *any* of the voting rights that its NBFIs possessed in affiliates, since this method was seen as a primary way by which *chaebol* families could exercise control over firms in which they had little equity ownership. However, due to fierce *chaebol* lobbying and cries that the prohibition would result in *chaebol* affiliates being taken over by foreigners, the Fair Trade Act was amended in 2002 to allow these *chaebol* families to employ the votes of NBFIs to exercise up to an aggregate of thirty percent of affiliate voting rights in member firms.[171] The battle

167. *See, e.g.*, *id.* art. 16; Specialized Credit Financial Business Act, No. 5374 art. 50-5 (1997), *amended by* Act No. 6430 (2001) (S. Korea); Act on the Business of Operating Indirect Investment and Assets, No. 6987 art. 12 (2003) (S. Korea).

168. *See* Korean Securities and Exchange Act, art. 191-19, *amended by* Act No. 7025 (2003), Act No. 7114 (2004).

169. *See* Commercial Code, No. 1000 art. 382-3 (1962), *amended by* Act No. 5591 (1998) (S. Korea).

170. In addition, Article 10 of the Fair Trade Act prohibits any firms within large *chaebol* from devoting more than twenty-five percent of their net worth to purchase the equity stakes of affiliates, but the *chaebol* have figured out ways to get past this requirement.

171. That is, *chaebol* families could continue to use the votes of non-financial firms to control affiliated firms without limitation like before, but NBFI votes could also be employed in controlling an affiliate firm until total ownership in that firm by all its affiliates reached the thirty percent mark. For example, suppose Firms A, B, and C

is not yet over, and the latest revision to the Fair Trade Act, which was passed in December 2004, calls for this percentage limitation to be gradually reduced to fifteen percent by April 2008.[172] Alongside this rule, Article 10 of the Fair Trade Act continues to prohibit *chaebol* firms from using more than twenty-five percent of their assets in acquiring stocks in affiliates, but financial and insurance affiliates are exempted from this rule as well.[173] Other exceptions also apply, and *chaebol* who have debt-equity ratios below one hundred percent will be exempted from the law entirely until 2007.[174]

Unfortunately, while the rationale behind the restrictions on NBFI voting rights is understandable, these restrictions are unlikely to result in a reduction of the ownership and voting rights gap. After all, the families can simply rearrange their cross-shareholdings and channel their voting rights through more non-financial firms to comply with the limit. Nor is it likely that Korean lawmakers will have the political will to seriously hamper the voting rights exercised by *chaebol* families to the extent that the latter would be forced to give up control over their firms. The *chaebol* exert immense political power, after all, and they have argued that such laws would make their firms more prone to foreign takeover.[175] Considering the inroads that foreign hedge funds have made in recent years, their fears do have an element of truth to them, and it is highly likely that the Korean public as a whole does not want to see their flagship firms

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each own twenty percent of Firm D, and all four firms are members of the same *chaebol*. Also suppose that Firms A and B are non-financial firms, Firm C is an NBFI, and no other affiliate firm has an ownership interest in Firm D. Under the 2002 amendment, Firms A and B would still be allowed to exercise their aggregate forty percent voting interest in Firm D, but none of Firm C's votes in Firm D could be exercised because the thirty percent aggregate limit had already been surpassed. Similarly, if Firms A, B, and C each owned twelve percent of Firm D, Firms A and B would be allowed to exercise their full twenty-four percent votes, but Firm C, the NBFI, would only be allowed to exercise half of its twelve percent interest (six percent) of its votes in Firm D because the thirty percent aggregate limit had been met.

172. *See* Fair Trade Act, No. 3320 art. 9 (Addendum, Dec. 31, 2004) (S. Korea).

173. *See id.* art. 10(1), 10(7), *amended by* Act. No. 6043 (1999) (S. Korea).

174. *See* So-Young Kim, *Rules Eased For Chaebol Investment*, KOREA HERALD, Feb. 15, 2005. Recently, the *chaebol* were even able to wrestle out of the National Assembly an exception for those groups which invest in certain high-tech growth industries. *See* Min-hee Kim, *Investment Cap to be Eased for Growth Industries*, KOREA HERALD, MAR. 11, 2005.

175. *See, e.g.*, Min-hee Kim, *Big Business Disappointed over Fair Trade Bill*, KOREA HERALD, Dec. 11, 2004.

taken over by foreigners, regardless of the personal views they hold on *chaebol* governance.

B. *Application of the Proposed Regulatory Structure to Korea*

In this light, the regulatory structure proposed by this Article would be especially useful in the Korean context.[176] It would place more emphasis on the financial benefits gained from *chaebol* control of NBFIs, rather than the voting benefits, and would thus not contribute to the unpalatable risk of foreign takeover. The "independent specialized bureau" could be set up within the KFTC, which possesses great expertise in intra-*chaebol* transactions.[177] Currently, the KFTC already engages in ad hoc review of intra-*chaebol* transactions for fairness, but it does so without the benefit of strong disclosure rules because the *chaebol* are only required to provide one consolidated financial statement of all related firms, with the exception of publicly listed firms.[178]

Of course, the proposed law may burden *chaebol* firms with higher terms of finance to the extent that they were able to enjoy preferential benefits through their NBFI connections, but as this Article has argued at length, this would precisely be the intended effect.[179] Furthermore, the increased burden resulting from the disclosure requirements would certainly be unwelcome to some, but such enhanced disclosure would likely result in the gradual reduction of the "Korea discount" and *chaebol* families could reap these benefits in future issuances of securities.[180] Fortunately, the enforcement of the disclosure requirements would be made easier by the power already possessed by KFTC to

176. As alluded to earlier, Korean law already prohibits *chaebol* from owning substantial stakes in commercial banks, on the model of the Bank Holding Act in the United States, and thus the proposed law would focus on NBFI affiliates.

177. The other obvious candidate is the Financial Supervisory Commission, which currently exercises jurisdiction over NBFIs. However, the author is of the opinion that the Fair Trade Commission would be the better option because of its decades of expertise in regulating the *chaebol* since the Fair Trade Act was promulgated in 1981.

178. *See* Nam et al., *supra* note 104, ¶ 129.

179. If there are concerns that such a law would amount to "over-regulation" in Korea, Korean policymakers could consider repealing the Fair Trade Act's limitations on the use of NBFI voting rights. After all, the entire rationale behind this regulation—the reduction of the ownership and voting rights gap in the *chaebol*—is highly unlikely to be realized through this regulation anyway.

180. *See, e.g.*, Mitton, *supra* note 8, at 227 (finding that East Asian firms with better disclosure were valued more highly, particularly during the Asian financial crisis).

trace the bank accounts of *chaebol* firms for evidence of illegal dealings.[181] Also, in response to concerns that such a law might amount to over-regulation, lawmakers could consider repealing the Fair Trade Act's limitations on the use of NBFI voting rights as a compensatory measure. As argued above, the main rationale behind the latter regulation—the reduction of the ownership and voting rights gap in the *chaebol*—is highly unlikely to be realized through this regulation anyway.[182]

Finally, observers may be skeptical of the effect that the proposed regulations would actually have in reducing the ownership and voting rights gap observed within the *chaebol*. After all, when some *chaebol* firms post record earnings, the *chaebol* will be less reliant on their financial institutions for internal finance due to solid retained earnings by non-financial firms. This argument misses the point, however, because any capital that stays within a business group is capital that is kept out of the market as a whole, and would thus contribute to the financing advantage of *chaebol* firms vis-à-vis other firms.[183]

At any rate, the main premise of the proposed law is that economic cycles come and go. Korea will hopefully never have to go through another economic crisis like the one experienced in the late 1990s, but economic downturns can and will happen. Yet when such downturns do happen, some of the weaker *chaebol* firms may find that they can weather the storm through their NBFI connections, when they would otherwise have had to merge with stronger firms or go bankrupt. The proposed law intends to rectify this effect, so that the playing field will be more closely evened for *chaebol* and non-*chaebol* firms, and market forces will be allowed to play their natural role. Thus, if certain *chaebol* do in fact invest resources inefficiently, these *chaebol* will simply have to bear the consequences as regular firms do.

181. *See Assembly Rushes to Pass Antitrust Law Revision*, KOREA HERALD, Dec. 10, 2004.

182. *See supra* note 179 and accompanying text.

183. *See* Almeida & Wolfenzon, *supra* note 51, at 129-30. At any rate, the size of such retained earnings must be kept in perspective, and it should be noted that a large chunk of the cash-flow rights of firms like Samsung Electronics are held by those with no ties to the family, and is thus not freely transferable to other firms. In the case of Samsung Electronics, over sixty percent of its equity is owned by non-Korean investors. *See, e.g.*, Samsung, Ownership Structure, http://www.samsung.com/AboutSAMSUNG/ELECTRONICSGLOBAL/InvestorRelations/CorporateGovernance/OwnershipStucture/index.htm (last visited Oct. 1, 2006).

CONCLUSION

The dominance of pyramid structures around the world, while perhaps not entirely surprising, gives rise to new ways of thinking about the fundamental problem of shareholder expropriation. While the equity structure of pyramids is what enables controlling shareholders to exercise control over property in which they have little equity interest, the advantageous terms of the pyramids' internal capital markets are what increase the amount of property brought into the pyramid in the first place. With an understanding of the financing role that pyramid structures play, solutions can be tailored to reducing the amount of property that controlling shareholders can expropriate as well as the incentive for such expropriation. In particular, the ability of firms to enjoy advantageous terms of finance within the pyramid, often through subsidization by affiliated financial institutions, gives them a partial shield against the disciplinary effects of the market and aids the pyramid in continually expanding in the face of outside competition. Thus, the adoption and enforcement of a law that reduces this advantage, to the extent that the advantageous terms of finance result from improper cross-subsidization by financial affiliates, would be a powerful and constructive step in that direction.

To be sure, this Article has not advocated a move away from concentrated ownership, and in fact, has proposed a solution that acknowledges the likely perseverance of family ownership structures. It thus parts with the ideas embraced by those like Hansmann and Kraakman, who argue that the control of the business groups worldwide will gradually disseminate to minority shareholders as product and financial market liberalization gradually weeds out those firms unable to compete amidst these disciplining forces.[184] Even if their bold thesis eventually comes true, there is a dire need for concrete policy measures that can effectively alleviate minority shareholder expropriation at the present time. The regulations proposed here attempt to fill the current need by attacking a chief source of the ownership and voting rights gap exploited by controlling shareholders.

To be sure, it is comforting to know that in countries like Korea, policymakers have recognized the perverse incentives

184. *See* Henry Hansmann & Reinier Kraakman, *The End of History For Corporate Law*, 89 GEO. L.J. 439 *passim* (2001).

that arise when families are allowed to control financial institution resources as well as non-financial firms which can be subsidized with them. Yet while they have found the right culprit, the solutions they have chosen will be of doubtful effectiveness because they do not decisively address the subsidization benefits received by *chaebol* firms through their financial affiliates. While the sky will not fall if Korea chooses to muddle through with the status quo, the limits to which the benefits of *chaebol* organization can be derived have already been met. Although the *chaebol* will likely remain a mainstay of the Korean economy, the "Korea discount" and the ability of *chaebol* firms to reap private benefits through NBFI affiliations should not. As Korea stands poised to join the ranks of truly developed economies, its future actions will hopefully serve as a fitting example for all countries where such private benefits are derived through pyramidal business groups.